<u>Monthly Outlook, July, 2017: "This time is different. No, really, it is!"</u>

> "Would I say there will never, ever be another financial crisis?...You know, probably that would be going too far, but I do think we're much safer, and I hope that it will not be in our lifetimes, and I don't believe it will be**.**" – ***Janet Yellen, June 27, 2017.***

The quote from Federal Reserve Chairwoman Janet Yellen (when she was answering questions after a speech in London) encapsulates the ***level of hubris*** that appears to be prevalent among policy-making circles. Surely, the Chairwoman knows that such a blanket statement is likely to come back to haunt her over time, just as Chairman Bernanke's famous "the sub-prime mortgage problem appears to be contained" in 2007!

Economic data released recently have been ***mixed***: The US economy added a greater than expected ***222,000 jobs*** during the month of June. Private sector payrolls accounted for 187k jobs with education and health services (+45k), professional and business services (+35k), and leisure and hospitality (+36k) leading the way. The beleaguered information sector (-6k) and manufacturing (+1k) were sectoral laggards.

The ***unemployment rate*** rose one-tenth to a still low ***4.4%***. The U-6 measure of underemployment (in our opinion, a more realistic picture of unemployment as it takes into account disaffected workers as well) also posted an increase of two-tenths to 8.6%. The Average Hourly Earnings figure rose a seasonally adjusted 0.4% (m/m; y/y: 2.5%) suggesting that ***wage pressures*** which have been hitherto non-existent are starting to build. Indeed, the Average Weekly Earnings figure rose 0.4% (m/m; y/y: 2.8%) during June suggesting further worries about wage inflation in the pipeline.

The Bureau of Economic Analysis of the Department of Commerce revised ***GDP growth for 1Q2017 to 1.4%*** (Seasonally Adjusted Annual Rate) from a previous estimate of 1.2% (also SAAR). While the revision appears to be heading in the right (correct) direction, overall GDP growth was still disappointing: Personal Consumption Expenditures (the vaunted strength in the US economy) rose 1.1% (from a previous reading of 0.6%), while government consumption and investment fell -0.9% during the period. Gross Private Domestic Demand was a bright spot, rising 3.7% for the quarter. Exports gained 7.0%, while imports also increased 4.0%.

Survey data – particularly those released by the Institute of Supply Management continue to indicate ***robust strength*** in the US economy: The Manufacturing Purchasing Managers' Index rose to 57.8 in June (from 54.9 in May), New Orders posted a sizable increase to 63.5 (from 59.5) and production also rose to 62.4 (from 57.1). Similarly, the Non-Manufacturing Survey (for service related industries) also posted nice gains: The Non-Manufacturing Index rose to 57.4 in June (from 56.9 in May) as the New Orders component rose to 60.5 (from 57.7).

Consumer confidence remains a key to continued growth of the economy. The Conference Board Survey of Consumer Confidence posted a nice gain in June to a level of 118.9 (from May's 117.6). While the Present Situation component of consumer confidence increased to 146.3 (from May's reading of 140.6), the Expectations Index declined to 100.6 (from May's 102.3). Clearly, other surveys (including the University of Michigan's computations) also seem to point to better confidence amongst individual consumers.

However, ***hard data*** like retail sales appear to have ***lost some momentum.*** The annual (year-on-year) increase in retail sales (including automobiles) has backed off to a (still positive) ***3.8% gain*** in May compared to a gain of 5.4% in January. Similarly, sales of automobiles including light trucks are currently running at an annualized 16.4 million units compared to 18.3 million units pace seen in earlier in January. Some of the loss of momentum in car sales might be as a result of automobile makers having the "wrong" kind of cars for sale. New car inventories are currently at 94 days of sales (quite high relative to a "normal" inventory in the range of 60 to 65 days – hat tip, Mr. Ed Guay).

Minutes of the FOMC meeting from June which were released last week, contained some ***unusually hawkish language –*** suggesting that we could see two more rate hikes this year (in September and December). In addition, the FOMC seemed to indicate that they would also ***start to sell*** some of their holdings of Treasury and Mortgage instruments into the market in order to ***shrink the size of their balance sheet, as early as, late this year.***

While it is not at all clear what the eventual size of the balance sheet after such "normalization" is complete is going to be, one can guess that this exercise involves a long drawn out process. If one were to assume that the Fed will likely shrink their balance sheet to twice the size it was before the credit crises hit in 2008 – then the appropriate size of the balance sheet would be roughly $1.6 Trillion. With the current size of the balance sheet at $4.46 Trillion, that would imply a shrinking of $2.86 Trillion over time.

The FOMC has also intimated that the sales would be conducted in a ***gradual and measured manner***, so as not to disrupt markets' normal functioning (whatever that means!). At the purported sale pace of $30 Billion per month, it would take the FOMC 95 months (***or almost eight full years!***) from when they initiate the process to complete the process of "normalization" of the balance sheet. Good luck with that!

The level of ***hubris*** among policy makers – especially as it relates to their ability to ***"control outcomes"*** is quite startling. Further, this is not a phenomenon that is just limited to the Federal Reserve. Speeches by Central Bankers from Europe as well as, the UK and Canada, seem to imply that they all feel comfortable that they have done a very good job of ***managing the global economy,*** without arguing the counterfactual that their intervention in these markets (and creating asset bubbles) might indeed be part of the problem, rather than the solution to a problem.

Farther afield, events in the Korean peninsula, specifically North Korea, seem to be garnering much geopolitical headlines: While a ***nuclear North Korea*** – especially one that is run by an unpredictable despot – is hard to contend with, we are afraid that events might conspire to have a deleterious effect on financial markets. After all, the capital of South Korea, Seoul, is within artillery range of the North Korean border and hostilities breaking out would represent a ***black swan type event*** for financial markets.

Prices for crude oil seem to have bogged down despite supportive fundamentals of supply and demand. Indeed, there are more reports of hedge funds and other leveraged players starting to believe that crude oil prices are likely to be mired in a $40 to $50 per barrel range for as far as the eye can see. Also, a recent Commitment of Traders Report from the CFTC shows speculators (non-producing hedgers) having the largest ever "short" position on crude oil in history. All of these data points, reiterate our belief that the prices of some of the stocks in the energy sector are trading at levels well below those justified by fundamentals. While the YTD underperformance in this holding ("XLE") has been disappointing, we remain steadfast in our belief that over the long haul fundamentals will and do eventually matter.

With companies beginning to report earnings for 2Q2017, it will be interesting to see the ***tenor of these reports***. Going into the quarter, expectations were for a year-on-year gain of 10.4% for the entire S&P500 index. Consensus expectations for the entire year 2017 remain at a fairly high gain of 20.7%. Valuation multiples are also quite high at 21.5 times trailing earnings results

In an environment where central bank liquidity is generally shrinking, interest rates are probably headed higher, and earnings expectations as well as valuation multiples are elevated, we believe having some cash on hand as dry powder is prudent, and it is ***important to proceed with caution*** even as others around us seem to be losing their heads!

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