<u>Monthly Outlook for July, 2018: "The Dog Days Are Over…"</u>

*"The dog days are over, the dog days are done, Can't you hear the horses, 'cause here they come,
With every bubble she sank with a drink, and washed it away down the kitchen sink…"*

("Dog Days Are Over" by Florence + the Machine, 1986-).

It is a tad bit optimistic of us to suggest in mid-July that the Dog Days of Summer are over especially since the mercury continues to hold steady around 95 degrees Fahrenheit here in Houston, TX. With the equity markets resuming their upward march, we do think it is appropriate for us to feel a little bit more positive for now – although Florence + the Machine also sing about washing away bubbles in a sink in the same song!

US economic data for the month of June came in ***better than expected***: The Bureau of Labor Statistics reported that the economy added a seasonally adjusted ***213,000 jobs*** during June. Notwithstanding the increase in jobs, the unemployment rate actually increased two-tenths of a percent to ***4.0% in June***. Further, the underemployment rate (or U-6 measure) also showed a small increase of two tenths of a percent to 7.8%.

Private sector jobs increased by 202,000 in June, with both goods producing (+53k) as well as service providing (+160k) jobs rising nicely. Education and health services (+54k) as well as professional and business services (+50k) posted the largest gains among sectors. The laggards for the month of June were trade, transportation, and utilities (-4k) and information (0k). The ***average weeks unemployed*** from the household survey witnessed another, albeit small, decline (to 21.2 weeks from May's reading of 21.3 weeks) – which was another positive for the labor market.

Average Hourly Earnings rose 0.2% (m/m; ***y/y: 2.70%***) in June, which continues to rise above the current rate of inflation – a bad sign for the longer-term health of the economy. The ***Average Weekly Hours*** for the month of May marks another month at a steady 34.5 hours. As earnings continue to rise above the current rate of inflation, we begin to wonder what, if any, changes will the FED make to their longer-term interest rate forecasts and their conduct of monetary policy.

Inflation readings in the US appear to remain ***fairly quiescent*** however: Producer prices (for final demand) rose 0.3% (m/m; y/y: 3.4%) for the month of June, but the ex-food and energy measure rose a more staid 0.3% (m/m; y/y: 2.8%). Consumer prices for urban consumers also posted a gain of 0.1% (m/m; y/y: 2.9%) while here too the ex-food and energy measure rose 0.2% (m/m; y/y: 2.3%). Many of the other inflation indicators we watch - including commodity prices - are ***starting to stir*** from their long stupor!

There is no question in our mind that the Federal Open Market Committee (FOMC) of the Federal Reserve will likely raise interest rates again at their ***September meeting***. Indeed, after the FOMC meeting in June, Chairman Powell – a man not ***generally used to hyperbole*** – was almost giddy in describing the state of the US economy. While the FOMC Statement from June appeared to be more direct and shorter (rather than the long winded language ***replete with modifiers*** which appeared to be favored by Chair Yellen), it did set up the expectation that the Fed is on course to raise interest rates at least ***two more times this year***.

The US Treasury yield curve for its part continues its ***relentless flattening***: The ***spread*** between the US Ten year maturity Treasury yield and the US Two year maturity Treasury yield is now a pancake flat 24.5 bps (a bp is 100^{th} of a percent for those of you keeping score at home). To wit, the spread between the Ten year

Treasury yield and a Five year Treasury yield is an even narrower 10bp – suggesting that an investor is hardly getting paid to extend duration out on the yield curve.

Why do we worry so much about the ***shape of the yield curve?*** There has only been one previous instance since World War II (in 1995), when an ***inverted yield curve*** (an unusual state of affairs where shorter maturities yield more than their longer maturity counterparts) did not lead to a ***recession***. Looking at the plethora of global economic data we monitor on a daily basis, a recession does not appear anywhere in sight, and yet an inverted yield curve would inject a note of caution to a sanguine growth forecast.

We are also on the verge of 2Q2018 earnings season which was kicked off in earnest by larger US banks last Friday. Going into this earnings season, the ***consensus is expecting an increase of 18.3%*** for the period (year-on-year comparison) with a gain in revenues of roughly 8.0%. For 1Q2018, earnings rose 24.3% (also a y/y comparison) on a gain in revenues of about 12.0% for the period. For all of 2018, second quarter's expectations implies an earnings growth rate of ***19.9% for the entire year***. In other words, analysts' earnings expectations are quite optimistic and there appears to be plenty of scope for disappointment.

Farther afield, economic data out of ***Europe*** suggests some slowdown in growth momentum (especially from the higher pace that appeared to be set during 1Q2018). Germany's IFO Survey posted a small decline in June (from 102.3 to 101.8) as the current assessment component declined (from 106.1 to 105.1) despite the expectations component holding steady (at 98.6). Retail Sales also posted an unusual decline in May -2.1% (m/m; y/y: -1.6%).

The European growth outlook is clouded by expectations that the European Central Bank will, in the not too distant future, have to start removing the additional stimulus it has provided to boost economic growth. This is also complicated by the advent of a few ***nationalistic*** governments in places like ***Italy and Hungary*** **-** where the citizens appear to be suggesting that they are getting tired of economic policy being made from Brussels **-** to the benefit of all of Europe.

A political crisis in the UK (with resignations by key Cabinet members responsible for ***Brexit negotiations***) appears to encapsulate the mismanagement and incompetence that unfortunately seems the hallmark of Theresa May's tenure as Prime Minister. Indeed, it was hoped that the "special relationship" that the UK shared with the US could lead to a ***most-favored nation*** bilateral trade accord amongst the two countries – but if only wishes were horses, pigs would fly too! Given the nature of the personalities of PM Theresa May and President Donald Trump, we find this to be a highly unlikely proposition.

Speaking of ***trade wars,*** we continue to be amazed at the amount of ***media coverage*** on the skirmish with China **-** as tariffs are imposed on a variety of goods **-** in a tit-for-tat manner. No question, the Chinese have played the world like a finely tuned Stradivarius for too long and continue to exercise their ***mercantilist tendencies with impunity***. While we do have some sympathy for President Trump's view on things like intellectual property theft, we wonder whether his methods will ultimately bear fruit.

As equity markets continue to ***grind higher***, we are thankful for the higher prices: We do expect more volatility as we get into late summer, especially as the outcome of the Congressional mid-term elections come into focus from a policy making standpoint. Congress (the Senate in particular) will be busy leading up to the elections dealing with a new ***Supreme Court Nominee*** and, as usual, the strident parts of both television and new media (on either end of the spectrum) will continue to ply their garbage at the unsuspecting public.

The dog days are not yet done, and while many market experts see bubbles in various asset classes, they are not being washed down the sink, at least, not yet (with apologies to Florence + the Machine!).

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