<u>Monthly Outlook: June, 2016: “Will She or Won’t She?”</u>

Many members of the Federal Open Market Committee (FOMC) have in recent speeches underlined their desire for higher administered rates. While much newsprint and airwaves have been expended on seeking the answer to the question embedded in this month’s title, in our opinion, it hardly matters whether they go in June or July. It matters more, as to whether they have managed to ***“paint themselves into a corner”*** or are able to navigate market expectations successfully without being disruptive or making a grievous error in policy.

Our ongoing fear is that the ***discretionary nature*** of the conduct of monetary policy by the Federal Reserve is fraught with risks. Indeed, the FOMC often appears to “listen” to markets and seems to take their cue from market reactions to their pronouncements rather than from underlying economic fundamentals. In an attempt to be more transparent, the FOMC unfortunately seems to have ***confused quality with quantity***: More press releases and speeches might provide an insight into the current thinking of members (both voting and non-voting), but it does not lift the ***“fog of confusion”*** prevailing among market participants.

As a result, expectations of the FOMC’s next move ***wax and wane*** based on the most recently released piece of economic data and the latest pronouncement by an FOMC member. Witness the building in of four rate increases in January for the rest of 2016 (after the famous rate hike in December last year), only to be followed by their reduction to two rate increases in March (after a dovish speech by Chairwoman Yellen then). This then led to the markets completely pricing out any rate hikes for the rest of 2016 in early May, only for markets to price in two or more rate hikes through the month only to be removed on disappointing labor market data.

The release of tepid labor market data has started yet another cycle of lowering expectations: The US economy added a ***paltry 38,000 new jobs*** in the month of May, with many sectors including information (-34k) and construction (-13k) posting disappointing results. Healthcare (+67k) and Government (+13k) were the leaders among job gains with the unemployment rate dropping three tenths to a cyclical low of 4.7%. Average Hourly Earnings were up a seasonally adjusted 0.5% (m/m; y/y: 2.5%) while Average Weekly Hours fell one tenth to 34.4 hours.

A strike by workers at Verizon during the week the establishment survey was conducted is being partly blamed for the lackluster jobs showing in May. Extremely wet conditions (we in Houston might have a thing or two to say about that!) in some parts of the country could have reduced construction activity. Nonetheless, it is hard to comprehend how the economy in aggregate could lose construction jobs in May, when weather conditions and temperatures are usually conducive for an increase in construction activity.

The household survey also showed a marked decline in the ***labor force*** (-458k), the number employed increasing by a paltry 26k and the participation rate dropping another two tenths to 62.6% - a number which suggests all is not that well with the labor market. The number of weeks that a median worker stays unemployed – a measure of how long it takes to find a new job - also fell to a cyclical low of 10.7 weeks (from 11.4 weeks). The U-6 rate of unemployment, a more robust measure of unemployment in our opinion, stayed relatively constant at 9.7%.

The Bureau of Economic Analysis of the Department of Commerce did revise Gross Domestic Product for 1Q2016 higher to 0.8% (q/q, seasonally adjusted annual rate) from a previous reading of 0.5%. The upward revision in GDP while welcome, is unlikely to sway opinions that the economy appears to be ***“muddling along at a snail’s pace”***. The real culprit in the shift down in GDP growth appear to be trade (meaning exports) as well as the lack of any follow-through in capital investment spending by businesses and perhaps even faulty seasonals.

Why do we think businesses are loath to put in new plant and equipment or make investment spending decisions for the long haul? Well, it does not take a rocket scientist to figure out that given all the policy uncertainties (fiscal, monetary, and regulatory), businesses more often than not are likely to hunker down and only spend when they have to. Indeed, with many events on the horizon (including the Brexit vote and the US elections in the fall), we do not anticipate a quick resolution of these uncertainties.

Speaking of ***Brexit***, the people of the UK are going to be voting on whether to stay or leave the European Union on June 23rd. We have characterized the vote as a real ***"roll of the dice"***, particularly since the outcome of the vote is binary. ***Binary outcomes*** are ***anathema*** for markets: They find it very hard to handicap the results – especially where the outcomes are dependent not on economic fundamentals, but on political propensities.

Latest polls do show the ***leave side*** having a slight edge (within the statistical error range) with still a substantial part of the population (10 – 15%) responding "don't know" or "undecided" to pollsters. Further, these polls are complicated by the fact that many younger people are not polled (they do not have a home phone number where they can be called for a survey), and as a general rule the younger folk tend to be pro-European. The older people who do respond to telephone surveys tend to be more euro-sceptic (as they can remember a time when the UK was not part of the EU) and seemed to be doing fine, thank you very much!

Even if the people do vote to leave, it is not at all clear that the path forward for the UK is clear – as the country would have to ***renegotiate*** a number of treaties and agreements with the rest of the EU in short order – these agreements probably number in the hundreds! We do know this: a vote to leave would be ***quite disruptive for global financial markets***, not just the UK equity markets or the Pound Sterling. It also goes without saying that a vote to leave would probably also embolden separatist forces in Scotland and Northern Ireland as well.

On the political front, the Republican Party's Presidential field has been rapidly ***winnowed down*** to Donald Trump as the last man standing. It is quite remarkable that the process has been this rapid: Indeed when Mr. Trump announced his candidacy in June of 2015, not too many people had given him much of a chance of becoming the presumptive nominee. On the Democratic side, Hilary Clinton is still fighting a battle of attrition with Senator Bernie Sanders, but with the California primary this coming week, here too the nominee is likely to be chosen.

The upcoming election campaign (with both major parties holding their conventions late next month) is likely to be one that has not been witnessed perhaps since the early 1800s – where opponents were often tarred and feathered as a method of public humiliation. We expect there will be plenty of fireworks and mud-slinging from both sides and we can't wait to witness the televised debates between the two leading candidates. In an odd paean to ***life imitating art***, the disapproval rating for both leading candidates seems to be higher than their individual approval ratings!

In terms of financial markets, US equity markets appear to be ***marking time*** having real difficulty making much headway, especially as expectations of the Fed's next move, along with disappointing economic data appear to have put paid to the bulls' ideas of climbing the proverbial wall of worry. On the other hand (how is this for classic economist speak?), the fact that markets seem to have real trouble posting consistent gains after the torrid moves in February and March of this year seems to buttress the case for the bears as well.

At the end of the day, it is not all that relevant whether the FOMC tightens monetary policy in June or July or even later this year. What matters is that they ought to move away from this ***schizophrenic attention*** to the latest speech or piece of economic data. The Federal Reserve ought to put in place an environment (from a monetary policy standpoint) that permits individuals and businesses to make investment and savings decisions for the longer term rather than lurching from one FOMC meeting to the next. Will she or won't she, indeed?

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