Monthly Outlook, June, 2017: "A Midsummer Night's Dream?"

With our apologies to the Bard of Avon, financial markets appear to be celebrating their own version of a ***Mid-Summer Night's Dream:*** A comedy, which is set simultaneously in the woodland as well as in fairyland under the light of an opalesque moon. The play contains a carnival like atmosphere, suggesting all is well with each of the four sets of lovers – despite their trials and tribulations! Similarly, market participants seem to be rejoicing at the prospect of further gains going forward, in ***wanton disregard of the inherent risks of an aging bull market.***

Economic data released recently has been ***mixed***: The US economy managed to add a ***paltry 138,000 jobs*** during the month of May, lower than the consensus expectation around 200k. Private sector payrolls accounted for 147k jobs with education and health services (+47k), professional and business services (+38k), and leisure and hospitality (+31k) leading the way. The government sector (-9k) as well as trade, transportation, and utilities (-6k) were the laggards.

The ***unemployment rate*** fell another one-tenth to a cyclical low of ***4.3%*** as the participation rate dropped another two-tenths to 62.7%. The U-6 measure of underemployment also posted a decline of two-tenths to 8.4%. The Average Hourly Earnings figure rose a seasonally adjusted 0.3% (m/m; y/y: 2.5%) suggesting that ***wage pressures*** were slowly but surely beginning to build – especially in the skilled sector of the work force. The "median weeks unemployed" – a measure of the length of time it takes an employee to find gainful employment deteriorated to 10.4 weeks (from April's reading of 10.2 weeks).

The Bureau of Economic Analysis of the Department of Commerce revised ***GDP growth for 1Q2017 to 1.2%*** (Seasonally Adjusted Annual Rate) from a previous estimate of 0.7% (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 a mere 0.6%, while government consumption and investment fell 1.1% during the period. Gross Private Domestic Demand was a bright spot, rising 4.8% for the quarter. Exports gained 5.8%, while imports also increased at 3.8%.

A number of developments on the ***geo-political front*** conspire to further increase the inherent risk in financial markets: Elections in the U.K., a spat between Qatar and Saudi Arabia in the Middle East and more US warships steaming to the Sea of Japan. While each of these events on their own has the potential to roil financial markets, taken together, they do up the ante on the risk of a sudden and virulent decline in markets. Let's look at each of these in turn.

While most polls in the U.K. suggest that Prime Minister Theresa May's ***Conservative Party*** is likely to win at the hustings, this is not a forgone conclusion: Ms. May has shown some ***vacillation in policy positions*** on pressure from the press and her dismal performance in the debates did not help her cause either. The Conservative Party's lead in the polls has shrunk considerably, but chances are they will likely still pull through, albeit with a smaller majority in Parliament.

The recent spat between Saudi Arabia and Qatar in the Middle East is interesting to say the least: The two States have often had differing positions on dealing with Iran (the other major power in the region) as well as other terrorist elements. The Kingdom of Qatar has ***"punched well above its weight"*** for a number of years, acquiring some cache when they were voted to host the Football (Soccer to us Americans) World Cup in 2022 and also gained the US Central Command Headquarters in 2009 at Al Udeid Air Base (from which the US fight against ISIS is waged). Qatar is also known to relish the role of a ***power broker*** in the region typically angering all the sides to a dispute!

Saudi Arabia (along with Bahrain, UAE, Yemen, Egypt and the Maldives) has ***cut diplomatic ties*** with Qatar on reports that the latter paid huge ransoms (in April) to terrorist elements to free members of a wedding party (including some members of the Royal family). In addition, Saudi Arabia has also given Qataris 14 days to leave the former Kingdom and banned overflights by Qatar Airways aircraft from Saudi Arabia. The Saudi move is seen as raising the stakes in the region, coming as it does within weeks of President Trump's visit to Saudi Arabia (where he unequivocally placed US interests in line with those of the Saudis).

Crude oil markets have been generally well-behaved despite worries that the diplomatic spat between Qatar and the other Gulf nations might lead to supply disruptions. While crude oil supply disruptions as a result of the diplomatic spat are quite far-fetched in our opinion, we suspect that ***fears of supply disruptions*** might drive the price of hydrocarbons much higher. A sharp increase in hydrocarbon prices would not be good for the global economy – especially as we fear that the US economy might be losing some consumer spending momentum when it comes to durable goods like housing and automobiles.

News that the USS Nimitz has left Bremerton, Oregon, last week and is likely to arrive on station in the ***Sea of Japan***, becoming the third US aircraft carrier in the region (in addition to the USS Carl Vincent and the USS John F Kennedy) suggests that US authorities might be planning military action in North Korea. How does the North Korean regime retaliate to such military action is a real question: Already, it is quite clear that North Korean artillery and missiles could reach the outskirts of Seoul (which sits barely 35 miles from the border with North Korea).

The Federal Open Market Committee of the Federal Reserve is also likely to raise rates again (by 25bp) at their meeting in mid-June – despite the latest Beige Book suggesting some modest loss of momentum in US retail spending. The European Central Bank for its part, could also announce at its council meeting (later this week) that the degree of monetary accommodation put in place is likely to be "tapered" later this year – especially as the European economy appears to be rebounding nicely.

With equity markets hovering near all-time highs, another issue that concerns us is the ***decreasing breadth*** within the markets: After all, much of the move in the indices has been isolated to a smaller and smaller number of high flying stocks like Amazon, Netflix, Alphabet, Apple and Facebook (to name a few). The fact that smaller capitalization indices have not kept pace with the larger market capitalization indices is also symptomatic of this declining breadth.

US bond yields have started to decline again, especially as more investors (both institutional as well as leveraged kind) feel that Treasury interest rates are ***unlikely to rise significantly*** even in the face of rising administered rates. The favorite "trade" among these investors is buying the longer end of the Treasury curve – to take advantage of a flattening yield curve – whilst also maintaining leveraged investments in equity markets at the same time. The difference between the ten year US Treasury yield and the two year US Treasury yield has fallen to 85bp from a high of around 147bp in early December, 2016.

In summary, geo-political events, narrowing breadth and high earnings expectations for the US equity markets make us even more cautious than usual. We do feel that markets have ***"thrown caution to the winds"*** as they continue to head higher. While such speculative phases do have a surreal quality to them (as everybody believes that markets can only go higher!), we have for long been trained to be ***skeptical of such widespread euphoria.*** We will therefore add our Cassandra like musings to the debate, hoping that the warnings we cite are not ignored like those of the famous Greek heroine. A Mid-Summer Night's Dream, indeed!

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