Monthly Outlook for June, 2018: "You haven't seen nothing like me yet…"

The storms are raging on the rolling sea, and on the highway of regret,
The winds of change are blowing wild and free, You haven't seen nothing like me yet!

("Make You Feel My Love" by Bob Dylan, Noble Prize winning singer, songwriter, and musician, 1941-).

While Mr. Dylan might have been professing his love with these lyrics, the last line in the stanza could well be appropriate for any number of politicians in today's ***#MemyselfandI*** world (to coin a Twitter hash tag!). Despite the positive momentum in US economic data, the ongoing skepticism amongst market participants suggests that equity markets could well march higher (even though we are in June!) in the near to medium term.

US economic data for the month of May came in **strong**: The Bureau of Labor Statistics reported that the economy added a seasonally adjusted ***223,000 jobs*** in May. Further, the unemployment rate fell one-tenth of a percent to ***3.8% in May*** – a level last seen in April, 2000 and December, 1969 before that! The underemployment rate (or U-6 measure) also declined another two-tenths of a percent to 7.6% in May.

Private sector jobs increased by 218,000 during the month of May with both goods producing (+49k) as well as service providing (+176k) rising nicely. Increases in trade, transportation, and utilities (+53k) as well as education and health services (+39k) posted the largest monthly gain. The laggards for the month of May were mining and logging (+4k) and the government sector (+5k). The ***average weeks unemployed*** from the household survey witnessed another decline (to 21.3 weeks from April's reading of 23.1 weeks) – which was another positive for the labor market.

Average Hourly Earnings rose 0.3% (m/m; ***y/y: 2.71%***) in May, 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 34.5 hours. While it would seem as though the existing workforce is not being pushed to put in longer hours, there are signs from the JOLTS survey that there might be more "job openings" than there are people "looking for jobs".

A low unemployment rate like we currently have (at 3.8%) is also a potential precursor to a ***recession.*** While none of the leading indicators we pore over in earnest are signifying such an outcome in the immediate future, history suggests that an unemployment rate below 4.0% is often followed by a period of recession about two to three quarters later (about six to nine months). We are not sounding the ***klaxon of recessionary alarm*** here, but merely observing that such low unemployment rate months have been followed by a recession in the past.

Overseas economic data has also been ***quite positive***: ***German GDP*** was reported to rise 2.3% (seasonally adjusted annual rate) for 1Q2018 and the IFO Survey also showed ongoing strength in both the expectations as well as the current conditions component (despite a slight decline in the level from late last year). Within the emerging markets, ***India*** continues to be a shining beacon of hope, with GDP rising a reported 7.7% (SAAR) for 1Q2018 – a rate that has been consistently above China's for the past few quarters.

Staying with overseas markets, ***Italian bonds and stocks were roiled*** last week when the President rejected a coalition government by two diametrically opposed political parties. The League (previously called the Lega Nord or Northern League), a center-right party with nationalistic ambitions entered into coalition talks with the Five Star Movement, a center-left Eurosceptic party. For us Americans, this would be akin to Bernie Sanders and Ted Cruz (who are obviously on opposite ends of the political spectrum co-sponsoring a Bill jointly in the Senate!). As it turns out, the leaders of the two political parties in Italy were able to find a compromise candidate for Prime Minister (Giuseppe Conte) and did manage to form a government and win votes of confidence in both the upper and lower houses of the legislature subsequently.

Italian bond ***yields soared*** as a result – with the ten year yield rising from around 1.75% to 3.16% in the space of a couple weeks - as fears of an existential threat to the Euro currency took hold. Italian two year yields also rocketed from a yield around -0.30% (***yes, negative 30bp***) to +1.36% - a move of over 160bp in little over two weeks. Italian equities also suffered similarly falling more than 12% during the same time. Recent statements by Monsieur Conte seem to suggest that fears of Italy leaving the Euro or abrogating its treaties were quite unfounded.

Spain also saw a change in its government, with Prime Minister Mariano Rajoy (of the Center Right People's Party) being forced out of office after he lost a vote of confidence in Parliament. This is the first time that a Prime Minister of Spain has lost a vote of confidence in Parliament in modern times. The leader of the Socialist Party, ***Pedro Sanchez***, was then elected Prime Minister. In comparison to Italy, the Spanish bond and equity markets do not appear to have missed a beat at all – accepting the change in government with ***equanimity***.

Closer to home, Minutes of the Federal Open Market Committee meeting held in mid-May as well as the Fed's own Beige Book released last week do point up another potential rate hike next week by the ***Federal Reserve***. We still feel that the Fed is on a path to normalization of interest rates as well as shrinking its balance sheet almost in ***"autonomous mode"***, meaning it would take a big shift downward in growth expectations for the Fed to not raise rates at its slow and steady pace. Despite the rate hike, monetary policy remains quite accommodative and the level of interest rates remains low from a historical standpoint.

The yield curve continues to ***flatten*** – with the spread between the Ten year Treasury yield and the Two year Treasury yield hitting a ***cyclical low of 41bp***. We have not had too many instances of such a flat yield curve without it being followed by recession in post-World War II history. The sole exception was in 1995, when Chairman Greenspan successfully managed a ***"soft-landing"*** of the US economy and growth resumed after a sluggish period.

The US Dollar went on a tear in May rising significantly against both the Euro and the Yen (especially as the former had worries in Italy, Spain and to a lesser extent in Turkey). Expectations of strong GDP growth added further fuel to the fire and a ***stronger USD*** also pummeled equity and currency markets in Argentina and Turkey. While we view the issues with some of the emerging markets as ephemeral, we also expect USD strength to be ***transitory*** – especially in the light of difficult ***"trade negotiations"*** not only with China and others but even with friends like Europe, Canada and Mexico.

Speaking of ***"trade wars"***, we are convinced that the tariff spat on steel and other goods is just that – a spat rather than an outright war. Indeed, while much newsprint and ink have been spilled on the speculation of what all this means, we are convinced that these gesticulations on trade are mere negotiating tactics – which will eventually allow the Administration to declare victory once they have "won a modicum of victory".

As US equity markets continue their grind higher, one potential risk remains the ***technology sector***: Valuations for this sector are quite stretched (and have been for a while, we should say!) and the technology sector's weighting in the S&P500 is now around 26.5% - a level we have not seen since the Dotcom Bubble days in early 2000. It would be foolhardy to predict a turn in technology valuations downwards or even argue for an imminent collapse as it is difficult to time these things. We do worry about valuations for this sector – call us "old fashioned" or "hide-bound". We do like a bargain when we see one, but technology today does not certainly appear to be one today! ***You haven't seen anything like me yet, indeed!***

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