Monthly Outlook for May, 2018: "Stuck in the mud…"

Doing nothing, stuck in the mud, just pumping the blood,
The water level's getting low, something ugly is going to show…"

(Lyrics to the song "Flotsam and Jetsam" by Peter Gabriel, English singer, songwriter, musician, lead flautist and vocalist for rock band Genesis, 1950-).

The above lyrics neatly encapsulate our ***current thinking on financial markets*** – the lack of follow-through buying despite stellar earnings reports and good fundamentals do point up something else that might be troubling these markets. Indeed, with equity markets appear to be ***"stuck in the mud"*** (with apologies to Peter Gabriel), we are continuing to re-evaluate all the positives associated with the market and casting a wary eye towards other indicators that are flashing warning signs.

Recent US economic data have been ***positive***: The Bureau of Labor Statistics reported that the economy added a seasonally adjusted ***164,000 jobs*** in April – slightly lower than the consensus expectations around 200,000. The unemployment rate fell one-tenths to ***3.9% in April*** – a level that has not been seen since December, 2000 – almost 207 months ago! The underemployment rate (or U-6 measure) also declined two-tenths to 7.8% in April.

Private sector jobs increased 168,000 jobs during the month of April with both goods producing (+49k) as well as service providing (+119k) rising nicely. Increases in professional and business services (+54k) and education and health services (+31k) posted the most gain, while both trade, transportation and utilities (-7k) and the government sector (-4k) brought up the rear. The ***average weeks unemployed*** from the household survey witnessed a marked decline (to 23.1 weeks from March's reading of 24.1 weeks) – which was another positive for the labor market.

However, the ***Average Hourly Earnings*** figure rose 0.1% (m/m; ***y/y: 2.6%***) in April, still rising above the current rate of inflation – a bad sign for the longer term health of the economy. Indeed, the ***Average Weekly Hours*** stayed fairly steady at 34.5 hours this month as well, suggesting that employers are not really pushing their existing workers to put in longer hours (which would be a dead giveaway of strains in the labor market) – not yet anyway! We still believe that as employers start to pay-up for talent, ***wage inflation*** will likely start to rear its ugly head and this could well cause the Federal Reserve to hike rates further.

The Federal Open Market Committee ("FOMC") did leave ***interest rates unchanged*** at its meeting on May 1st and 2nd, but the Statement accompanying the meeting did provide plenty of room for them to hike rates at the next meeting in June (June 12th and 13th). We do believe that the FOMC is on a gradual path to increase interest rates (at 0.25% per calendar quarter) until they feel that they have achieved their objectives. We do feel, however, that the peak in administered interest rates this time around could be considerably lower than the last peak seen in 2006/2007 (5.25%).

Further, the FOMC of 2018 is to some extent more ***"hawkish"*** than its predecessor from earlier years: Fed Chairman Jerome Powell and his colleagues are unlikely to fritter away the gains in ***inflation credibility*** gained painstakingly by the institution over many years. Also, the last thing that the Powell Fed wants to be blamed for is an ***economic recession*** it caused by raising rates too quickly or raising them too high. Essentially, the FOMC has to perform a tight rope walk in order to thread the needle between being too easy and too tight on monetary policy (how is that for mixed metaphors?).

Farther afield, the global financial media has been watching with bated breath as a US economic and trade delegation met with its Chinese counterparts in Beijing. US Treasury Secretary Steve Mnuchin led the delegation and while it appears that ***"some progress" was made***, more remains to be done. Chinese officials for their part made it sound as if the meeting was routine and much that was discussed within the hallowed "Great Hall of the People" was expected and not at all earth shattering.

Media reports seem to indicate that the US delegation wanted to see a commitment from the Chinese to reduce their trade deficit with the US by at least $200 billion per year over the next few years. The Chinese are past masters at ***obfuscating language*** which would imply a timetable that only they would find ***"reasonable".*** Regardless, we find it curious that President Donald Trump's confrontation with the Chinese on trade has been a surprise to many in the media – a position that had been well advertised to his constituency during the Presidential campaign.

We also find it quite odd that there are many so called "experts" in the media that are worrying about the risk of a ***"trade war" with China***. It is abundantly clear to us that China has over the many years since its ascension to the World Trade Organization (way back in 1995), played hard and fast with its promises to liberalize its trade and its currency management of the Renminbi Yuan. Indeed, the entire Asian currency crisis (1997/98) and the subsequent default of Russia and Brazil (1998) can be directly traced to a disastrous ***devaluation of the Yuan in 1995***.

Closer to home, ***corporate earnings reports*** appear to be coming in much better than expected: With 408 of the S&P500 companies (=81.6%) having reported so far, in aggregate, we have seen a share-weighted earnings gain of ***24.8%*** for 1Q2018 (compared to 1Q2017's 15.5% earnings growth). Going into the quarter, expectations (which we thought were elevated to begin with) were for a 16.0% gain in earnings. Of these 408 companies, 326 (=79.9%) have ***had positive surprises***, 24 (=5.9%) met expectations and a mere 58 (=14.2%) had negative earnings surprises.

In looking at the various sectors, ***all eleven sectors*** of the S&P500 have posted share-weighted gains in earnings, with increases in energy (+66.9%) and information technology (+35.3%) leading the way. Real Estate (+10.0%) and Consumer Staples (+11.7%) appear to be the laggards in this earnings train. Also, on an ***ex-financial basis***, S&P500 companies have seen a 24.2% growth in earnings for 1Q2018 relative to 1Q2017.

Clearly, the earnings story has been an unabashedly positive one, and yet, the US equity market appears to be "stuck in the mud" having difficulty making much headway if at all. Some of this might well be the result of the axiom that the ***earnings news is from the past***, and markets often tend to be anticipatory rather than reactionary in how they perceive change at the margin. It might also be worries about rising interest rates (the US Treasury Ten year yield did touch 3.0% for a brief period) or a relentless ***flattening of the yield curve.***

The yield spread between the Ten year US Treasury and its Two year counterpart has narrowed significantly this year to 45bp (with the Ten year to Five year spread an even flatter 16bp). Further, using a proxy for corporate borrowing costs (Baa yield) and that of Prime rate (or a "natural rate") produces a spread named after the famous Swedish economist Knut Wicksell – which now seems to be flashing orange (if not outright red!) suggesting that ***"something ugly is going to show"*** (hat tip to Mr. Guay for this!).

In summary, while equity markets have struggled to find their footing even amidst famously "great" earnings reports, we still think ***caution is warranted.*** We will therefore look to raise cash in your portfolios over the coming weeks – especially if it looks like ***markets are getting exuberant*** again like they did in late January. While we ***might well be early*** on our call, we would certainly place this under the category of "it is better to be early than late" when it comes to some of the more important things in life!

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