<u>Monthly Outlook, September, 2016: "Here in the real world…"</u>

This month's title is from a song that launched the career of country singer Alan Jackson in 1989:

> "Cowboys don't cry, and heroes don't die
> Good always wins, again and again
> And love is a sweet dream, that always comes true
> Oh if life were like the movies, I'd never be blue
>
> But here in the real world, it's not that easy at all…".

These lyrics remind us of the futile ***"experiment"*** that Central Banks around the world appear to be undertaking in an attempt to spur economic growth: Futile, because despite their protestations to the contrary, all their efforts have managed to do is raise the prices of risk assets beyond the pale of reasonability.

US economic growth appears to have ***stumbled*** this summer: The economy added a smaller than expected 151,000 jobs in August with most of the jobs coming in the services sector. The goods producing sector (mining and logging, construction and manufacturing) was responsible for a net loss of -24,000 jobs while service providing sectors added +175,000 during the month. Education and health services (+39k), trade, transportation and utilities (+34k) and leisure and hospitality (+29k) were the best sectors in terms of jobs added.

Average hourly earnings – an economy wide measure of ***labor income*** – gained a paltry 3 cents for the month to $25.73 taking the twelve month gains to a still tiny gain of 2.35%. The average work week – also an economy wide measure of ***output*** – fell one-tenths to 34.3 hours, suggesting that all is not well with the underlying economy. Average weekly earnings – another economy wide measure – posted a disappointing gain of 1.93% for the past year.

The politically sensitive ***unemployment rate*** remained unchanged at 4.9% as did the labor force participation rate (at 62.8%) and the employment to population ratio (59.7%). A broader measure of unemployment dubbed the U-6 measure by the mavens at the Bureau of Labor Statistics – that seeks to capture the nature of under-employment in the economy – also remained unchanged at 9.7%.

The Institute of Supply Managements' Purchasing Manager's Index witnessed a ***surprising drop*** to 49.6 in August (from July's 52.6 reading). A drop below the 50 level suggests that the manufacturing economy is contracting – a theme that appears to have been reiterated by the labor market report as well. Indeed, many of the components of the ISM report like new orders (49.1 in August versus 56.9 in July), production (49.6 versus 55.4), employment (48.3 versus 49.4) and backlog of orders (45.5 versus 48.0) show a distressing decline which ***"bears" watching (pun intended)!***

The Bureau of Economic Analysis also pegged ***Gross Domestic Product growth*** in the US economy at a meagre 1.1% (seasonally adjusted annual rate) during its second revision for 2Q2016. While personal consumption (at 4.4%) was a bright spot, gross private domestic investment (at -9.7%) stuck out like a sore thumb. Exports rose 1.2%, while imports gained 0.3% during the quarter. Government consumption and gross investment also fell -1.5% during the quarter.

In a much heralded speech at the Aspen Institute in Colorado imaginatively titled "Remarks on the U.S. Economy" (sic), Federal Reserve Vice Chairman ***Stanley Fischer*** argued that the slowing in productivity growth had been responsible for some the abysmal growth performance. Productivity is thought of as "output per man hour" - a relatively simple concept to understand, but a ***devilishly complex*** one to measure and interpret. Dr. Fischer also cited statistics to imply that the slowing in productivity gains have been a more recent phenomenon.

According to Dr. Fischer, output in the US economy had gained an annual average of 3.6% (saar) during the period from 1949 through 2005, but has gained a much slower 1.6% from 2006 through 2015. ***Productivity***, which posted annual gains of 2.5% during the period 1949 through 2005 has also slowed to 1.2% during the period 2006 to 2015. He goes on to suggest that some of the issues might be related to the measurement of productivity or the slowing pace of technological innovation. He fails to make the obvious connection between slowing productivity growth and quantitative easing put in place by the Fed in 2008.

It appears to us that the Fed has now adopted "full employment" to the ***exclusion*** of "stable prices". While declining inflation is a problem (as we all recognize), we now have patchy evidence of the inflation genie starting to get out of the proverbial bottle. It is interesting that the market now appears to be coalescing to a view that we need some sort of ***fiscal stimulus*** no matter who gets elected in November. Given that monetary policy has been ineffective we now need to try fiscal policy to fix this mess. What was it that Einstein said about insanity? "Doing the same thing over and over again expecting a different result every time".

Intervention by the Central Banks around the world is real ***nuts*** – to coin a technical phrase. ZIRP, NIRP, QE and all their cousins were first used as an "***emergency***" measure – when clearly the economic patient was in intensive care. Now that the patient appears to have recovered somewhat, there should be absolutely no reason to continue to be administering the lethal cocktail of drugs that the quacks (read the Federal Reserve) seem to be prescribing.

The Bank of Japan continues to push the envelope on ***interventionist policies*** – head and shoulders above all the other central banks. Look at a chart of the size of the BoJ's balance sheet relative to the size of the Japanese economy and it becomes readily apparent that the BoJ has abandoned any modicum of allowing fundamentals to determine such mundane things like the level of interest rates or even the valuation multiples for equities. Indeed, with the BoJ on pace to accumulate almost two-thirds of the ***free float*** on a number of equities that trade on the Nikkei 225 Index, one wonders where does this all end?

The ***European Central Bank*** and the Fed are not that far behind the BoJ, for that matter. The ECB appears to have also let it be known that if the negative rates they have put in place do not work effectively, they will simply take rates even more negative – more shades of insanity! Europe has bigger problems to deal with, including ***Brexit*** and a rising anti-immigration sentiment on the continent. Add to this potential bank problems in Italy and Germany and you truly have a witches brew.

Speculation is now rampant as to whether the FOMC will ***raise rates*** at their next meeting, scheduled for later this month. We could go either way on this, as the FOMC has in the past demurred when conditions were prevalent for them to go (September 2015), and did go when the consensus had essentially given up on them (December 2015). Despite all the gnashing of teeth and wringing of hands, we do not think that a ***25bp move*** by the Fed will impact markets in a big way in either direction.

With the end of summer, the ***US Presidential elections*** come to the fore: The debates will be interesting to say the least, but we expect the race to tighten (as it always invariably does). The consensus currently appears to be betting that Hillary Clinton will win in November, with a possibility of the Senate changing hands. The House however, is likely to remain Republican controlled – albeit with a smaller majority. We have for long had the ***opinion*** that betting on election outcomes is fraught with risk and we are not about to change that notion now.

Volatility continues to decline: Indeed, we have had almost 50 trading days with the S&P500 not moving more than 1.0% from its close the previous day – a phenomenon not seen since the early 1990s. As the saying goes, it is quiet, perhaps too quiet. We are convinced that this quiet is likely to lead to a rude awakening going forward, as ***"here in the real world, it is not that easy at all"!***

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