Monthly Outlook, September, 2017:

"High water risin', the shacks are slidin' down, Folks lose their possessions—folks are leaving town… Things are breakin' up out there, High water everywhere"

Bob Dylan, Nobel Prize Winning American singer, songwriter, and musician (1959 –)

We had originally planned to quote Bob Dylan's "A Hard Rain's A-Gonna Fall" but ***Hurricane Harvey*** took the wind out of those proverbial sails (pun intended)! Last week, Hurricane Harvey devastated Texas. While the scenes of high-water rescues on television and flooded freeways were all too real, we do believe this too shall pass – Houston will rebuild and come back stronger than ever: It is after all, the Texas way! ***If you have been impacted by Hurricane Harvey and need help in any way, please do not hesitate to call or email us. We are here to help.***

Onto more ***prosaic details***: The US economy added a smaller than expected ***156,000 jobs during August***. Revisions to June and July figures showed that 41k fewer jobs were created than originally reported. Private sector payrolls accounted for all 156K jobs: Manufacturing (+36k), Construction (+28k), and Professional Business Services (+40k) led the way, while Information (-8k) and Government (-9k) suffered losses. August job numbers were below the twelve-month average of 180k jobs per month, well below the peak gain of 260.75k per month witnessed in February, 2015.

The politically sensitive ***unemployment rate*** reversed its downward trend by ticking up another one-tenth to ***4.4%.*** The ***U-6 measure of underemployment*** (in our opinion, a more realistic picture of unemployment as it takes into account disaffected workers as well) remained unchanged at 8.6%. The Average Hourly Earnings figure held steady at a seasonally adjusted 0.1% (m/m; y/y: 2.5%) and the Average Weekly Earnings figure fell 0.3% (m/m; y/y: 2.6%) implying ongoing worries about ***wage inflation in the pipeline.***

The Bureau of Economic Analysis of the Department of Commerce pegged ***GDP growth for 2Q2017*** at 3.0% (Seasonally Adjusted Annual Rate), a big improvement from the first quarter's pace of 1.2% (also SAAR). Personal Consumption Expenditures (the vaunted strength in the US economy) rose 3.3%, gross private domestic investment increased 3.6%, exports gained 3.7% while imports rose 1.6% and government expenditures fell -0.3% (all SAAR).

Consumer prices continue to show a decline in the ***rate of inflation:*** The Bureau of Labor Statistics reported that consumer prices for urban residents rose a mere 1.7% (y/y) on an ex-food and energy basis during the twelve months ended July, 2017 – a rate that is well below the "desired" 2.0% of the Federal Reserve. The Personal Consumption Expenditures deflator (which is computed and published by the Department of Commerce as part of the GDP release) also rose a mere 1.4% (y/y) – also for ex-food and energy items.

Clearly, there appears to be a ***sizable disconnect*** between a falling unemployment rate and a consumer inflation rate that has not increased much. Indeed, this year both the measures of inflation have ***fallen***, despite an unemployment rate that has also declined. Call it the revenge of the robots (or automation) or excess capacity in the economy, but many economists including those at the Federal Reserve are at a loss to explain this unusual phenomenon.

The Federal Reserve is likely to announce a ***shrinking of its balance sheet*** beginning next month perhaps at the Federal Open Market Committee meeting that ends on September 20th. The consensus among Fed watchers is for no increase in the Federal Funds Rate (with 70 out of a total of 82 economists not expecting a change on a Bloomberg Survey) at that FOMC meeting. However, the FOMC minutes of the July meeting published last month did indicate that the Fed was likely to begin the process of shrinking its balance sheet by reducing the holdings of Treasuries and mortgages ***"soon".***

Farther afield, European Central Bank President ***Mario Draghi*** appears to signaling that the ECB might start its own "tapering" soon – especially as economic growth now appears to be hitting on all cylinders. Survey data (like the IFO in Germany) seem to suggest that the European economy might finally be meaningfully improving and the Euro currency, which has steadily climbed against the Greenback this year, seems to be appreciating in anticipation of such good tidings.

The ***debt ceiling deal*** along with an appropriation for Hurricane Harvey has ***stunned many in Washington DC.*** This was the President reaching across party lines to get a deal done with the help of Democrats in Congress. While the move has managed to marginalize the Republicans in Congress (especially Republicans in the Mitch McConnell and Paul Ryan mold), a definite outcome is that tax reform just got more complicated and any attempts at a ***balanced budget*** have now been consigned to a heap of history.

We do expect ***deficits to rise significantly*** going forward – especially as what little spending restraint that existed before – has now been circumvented by President Trump and Congress. President Trump is known to favor further deficit spending, particularly to fund his election promises like infrastructure spending and the border wall. In addition, his working with Senator Schumer and Minority Leader Nancy Pelosi makes it very unlikely that he can get sufficient votes for tax reform this fall or even next year.

In addition, to highwater caused by our leaders at home, is the highwater caused by ***Kim Jong-un of North Korea.*** The regime continues test intercontinental ballistic missiles and weapons of mass destruction, despite recently imposed sanctions. Every additional test has had less of an impact on global market volatility than the previous test – as more and more market participants are inured to such saber rattling.

However, with three aircraft carrier groups of the US currently stationed in the Sea of Japan, tempers fraying and the Chinese generally being unhelpful in solving this problem, things could well come to a head. We still believe that the chances of an outright war breaking out on the Korean Peninsula are quite small. Ongoing intransigence by North Korea like announcing the development of a weaponized Hydrogen Bomb, which has been mated to an intercontinental ballistic missile, are provocations. While Kim Jong-un might be ***homicidal, suicidal he is not!***

Many are calling Harvey an ***800-year flood.*** FEMA estimates that Houstonians could face up to $75 billion in personal property damage. The main concern is that "Folks lose their possessions—folks are leaving town". It is important to remember that Houston became the country's fourth largest and most diverse city, because of its attractiveness to new businesses as well as its light regulatory touch. It is estimated that 30% to 40% of small businesses never reopen their doors following a flood disaster, but it shall be rebuilt.

On the heels of Hurricane Harvey come Hurricanes Irma (which appears to be making a beeline for Florida) and Jose. Many market participants believe that the rebuilding from Hurricane damage is a positive for economic growth. We have a slightly more nuanced view on this: While the rebuilding from property damage does show up in GDP statistics, what is missing is the mental anguish and heartbreak that people suffer during such periods – which, by the way, is not accounted for in economic statistics.

High waters such as those occurring from economic policies, political risks, and geopolitical threats continue to erode the foundation of the second longest bull market in US history. We want to be prepared for the inevitable next recession and/or an intermediate correction. We believe it is important to keep extra cash on hand as ***"flood insurance",*** knowing full well that we sacrifice ***relative performance*** as a result.

When the next recession does occur we ought to remember the images of strangers helping one another during Hurricane Harvey regardless of their economic, political, religious, and racial backgrounds. After all, a recession is not just the end of the current economic cycle but the birth of the next. Yet again, we are reminded of the ***triumph of the human spirit*** and all that is good with helping one's neighbors and fellow brethren in the face of such adversity. High waters, indeed!

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