Monthly Outlook for September, 2018: "As Good As It Gets…"

"Oh, I bet that, this is as good as it gets, yes. How can you ask for more?
If you're paid you're not poor. This is as good as it gets, yes.
We've been bought, we've been sold. But least we're not old"

("As Good As It Gets" by Gene, from their Album, "Revelations").

It is perhaps axiomatic of us to imply that this is as good as it gets to quote the British Indie band Gene from their Revelations album (published in 1999). Certainly the fundamentals of economic growth in the US are strong, earnings appear to be better than expected and equity markets are within a whisker of their all-time highs. But the question needs to be asked – Is this good as it gets?

US economic data for the month of August has come in ***better than expected***: The Bureau of Labor Statistics reported that the economy added a seasonally adjusted ***201,000 jobs*** during the month. Notwithstanding the increase in jobs, the ***unemployment rate*** stayed steady at ***3.9% in August***. Further, the underemployment rate (or U-6 measure) also showed a small decrease of one-tenths of a percent to 7.4%.

Among the sectors, Professional and Business Services (+53k) and Education and Health Services (+53k) lead the way, while Information (-6k) and Manufacturing and Government (-3k each) brought up the rear. The ***Average Hourly Earnings*** figure rose 2.92% (year-on-year) for the twelve months ended August, 2018 while the Average Weekly Earnings figure gained 3.20% (year-on-year) for the same period.

The ***Household Survey*** saw a large decline in the Civilian Labor Force (-469k) compared to last month's gain (+105k). Similarly, the number of workers not in the labor force (for whatever reason) also witnessed a big increase (+692k). Measures relating to the Average Weeks Unemployed (22.6 weeks) and Median Weeks Unemployed (9.1 weeks) all indicate ***continued strength*** in the labor market.

In other survey news, the Institute of Supply Management's ***Manufacturing Index*** for August posted a sizable gain (to 61.3 from 58.1 in July) as many of the components including New Orders (65.1 versus 60.2), production (63.3 versus 58.5) and Backlog of Orders (57.5 versus 54.7) saw significant increases – suggesting that the manufacturing sector's strength remains quite robust.

A similar ISM Non-Manufacturing (or ***Services) Survey*** also showed an outsized gain for August (58.5 versus 55.7) with many of its components like New Orders (60.4 versus 57.0), New Export Orders (60.5 versus 58.0) and Business Activity (60.7 versus 56.5) rising strongly. Here too the services sector emerges as being in ***fine fettle*** with very little to worry about going forward. Is this as good as it gets, then?

Despite all the sanguine news on the economic front, it is ***not all roses***: ***Wage inflation*** appears to be ***accelerating***, especially in an economy that appears to be already at "full employment". With very little in the way of "spare labor capacity" (yes, that is what an economy at full employment implies!), workers demand a larger share of the profits – thus increasing wages over time. While higher wages are a positive, declining margins (which is a corollary of higher wages), also has a ***negative effect*** on corporate earnings.

The Federal Open Market Committee of the Federal Reserve, the body that is tasked with setting interest rate policy, will likely increase rates by another notch (25bp) at their meeting later this month (Sep 25th and 26th). Absent a sudden collapse in equity markets or the economy coming to a standstill (neither of which appears to be in the cards for the near to medium term), we fully expect that the ***September rate hike*** will be followed by another one of similar size in ***December***.

We had previously thought that the Federal Reserve would probably tighten two more times next year (in 2019), which along with the two rate hikes this year would take the Fed Funds Target to 3.0%. However, if US ***growth momentum continues unabated*** (and some of the signs do point to such an outcome), we would not at all be surprised by a total of ***four rate hikes next year***, taking the Fed Funds Target to 3.50%. Regardless, we expect the pace of rate hikes to remain gradual and with no change in cadence of 25bp per calendar quarter.

The yield curve (or the difference in yield between a ten year US Treasury and a two year US Treasury) continues to ***flatten.*** Indeed, the yield spread between the ten year and the two year got as low as 18bp late last month. To put this in perspective, the same spread stood at 52bp at the start of the year in January and was actually 82bp this time last year. The ***relentless flattening*** has caused many analysts to question the yield curve's efficacy as a signaling mechanism of an ***impending recession.***

While many analysts believe that the long end of the yield curve has been ***artificially manipulated*** by the large holdings of US Treasuries on the Federal Reserve's balance sheet, we are also quite familiar with the dangers of suggesting that ***"this time it's different"***. Regardless of one's opinion, an inverted yield curve in our view, is not a good thing – not that it is merely a ***harbinger of bad tidings*** for the economy (and by implication for the markets) – it is also symptomatic of the lack of real credit demand in the economy which does have larger implications for longer term asset returns as well.

The ***US Dollar*** has been on a tear lately – against both other developed country currencies as well as emerging market currencies (more on this later). Some of the US Dollar's vaunted strength might be the perception that US interest rates (at least the administered kind) are going to go higher than previously anticipated. However, the strength in the US Dollar has also hurt investments that are denominated in non-Dollar currencies. Indeed, international markets have continued to labor under a stronger US Dollar despite their fundamentals (especially cheaper valuations).

Emerging market currencies – primarily those of Turkey (the Turkish Lira – has a three letter symbol ironically called "TRY"), Brazil, Argentina, India and South Africa – have posted sizable declines recently. No doubt, the declines in the Turkish Lira have had something to do with President Erdogan's current spat with the US Administration (as well as abdominal fundamentals relating to current account deficits and deteriorating inflation). Declines in the Brazilian Real, the Argentinian Peso, the Indian Rupee and the South African Rand have more to do with specific issues relating to each of those countries.

Nonetheless, a number of economists have been quick to point out the widening currency woes in many of the emerging market countries as a ***contagion,*** similar to the Asian currency crises two decades ago (1997-1998), which led to significant declines in US administered rates at that time. While we do see the risks of contagion among emerging markets, we do not see this as a 1997 style crisis. We continue to monitor the virulent sell-off in emerging market equities with a view to making an allocation to this asset-class at some point in the future – especially if the sell-off manages to ***unearth real value*** for client portfolios.

With the Labor Day Holiday now in the rear view mirror, US markets will also likely focus more on the outcome of the ***Congressional elections*** to be held on November 6th. While the consensus belief is that the House of Representatives will likely change hands (as the incumbent party tends to lose about 24 seats on average during a mid-term election), the Senate becomes a much more difficult proposition to call – especially as the Democrats have more seats to defend during these elections than the Republicans do.

As the Indie Rock Group, ***Gene, sang in 1999***,*"Oh, I bet that, this is as good as it gets, yes…. How can you ask for more?"*

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