

**“If we fail to anticipate the unforeseen or expect the unexpected in a universe of infinite possibilities, we may find ourselves at the mercy of anyone or anything that cannot be programmed, categorized, or easily referenced.”**

**Agent Fox Mulder, The X-Files**

## **IN FOCUS: Looking Back – in an Attempt to “Anticipate the Unforeseen”**

The popular averages (typified by the S&P 500) ended the first six months of the year in positive territory +3.84% at the close of the quarter, after rebounding back from the initial reaction of the British people voting by a 51.9% majority to leave the European Union at the end of June. This latest relief rally is notable because the preceding panic attack was so fleeting. The Brexit shocked markets causing a three-day selloff in the U.S. market by a remarkable 5.3% following the Brexit vote. Since then equity markets have pushed back into record-high territory. As we are keenly aware markets hate uncertainty. However, the uncertainty caused by the unexpected vote in the UK to leave the EU also increased the likelihood of more easing by the overseas central bankers, particularly the Bank of England and supported a stronger U.S. dollar response. This increased the odds that the Federal Reserve will not hike rates for the foreseeable future. In other words, the bulls got recharged on the old mantra “Don’t fight the central banks.”

**Almost since the start of the bull market eight years ago, one can observe that there have been a series of panic attack corrections followed by relief rallies to new cyclical highs and then onto new record highs.** Since U.S. investors were traumatized by the financial crisis of 2008, it still doesn’t take much however, to convince them that the world is coming imminently to an end. Of course, the major central bankers were also deeply impacted by the events of 2008 and it comes as no surprise that they quickly conclude that they must also provide another round of ultra-easy monetary policy to avert a repeat of the financial crisis as well. Everyone’s primal fear is that the next crisis will be the widely dreaded endgame scenario - a financial crisis unstoppable by central bankers who have run out of tools in their toolkit.

***Do low rates imply an imminent recession?*** The U.S. bond market certainly isn’t fighting the central banks. However stock investors have to be especially impressed that the 10-year Treasury yield remains below 1.6% so late in the cycle despite Friday’s stronger-than-expected payroll employment report and the subsequent rally to new highs in stocks. Of course, leading the charge have been interest-rate-sensitive stocks. Previously, we have observed that negative interest rates in the Eurozone and Japan are of serious concern reflecting the fragility of global credit markets and ultimately pulling down US bond yields. Following the Brexit vote, the federal funds rate futures market implied no change in Fed policy for the ensuing 12 months. This is certainly consistent with our forecast since the end of last year that the one-and-done or perhaps even a delay was the most likely outlook for a rate hike this year. It also has contributed to the bond rally, especially in the U.S. In the past, the Federal Reserve rarely gave much weight to overseas economic developments. Now that the Fed seems to be doing so, the impact of U.S. monetary policy has also globalized the U.S. bond market.

**However, at the same time we are not convinced that the bond market is signaling a recession in the U.S. or even in the global economy.** It is confirming that overseas central banks will continue to pursue their ultra-easy monetary policies, and that the Fed will postpone additional rate hikes. Undoubtedly, the negative official interest rates of the ECB and BOJ are major contributors to the race to zero and into negative real rates (adjusted for inflation) in bond yields. So is the ECB’s corporate bond-buying program, which started in June may be hard to implement given that the mania by investors that are “reaching for yield. The resultant effect is a flattening of the yield curve to near zero percent and longer term could dampen profits for banks and other financial intermediaries.

## ***Observations on an Election Year:***

**On balance, the aftermath of elections tend to coincide with recessions and bear markets.** However, there have been exceptions, and we remain bullish about the current outlook for the economy and the stock market. That's partly because Fed officials are likely to postpone another rate hike until after the election, as they often have in the past. Since 1947, when quarterly GDP was first compiled, there have been 17 presidential elections. There were 11 recessions over this period according to Ned Davis Research, and almost all of them either coincided with elections or occurred shortly thereafter. There were only five instances when there was not a recession between elections.

**The political cycle does suggest an increased probability of a recession next year.** We're not sure what Hillary Clinton might do to cause one if she becomes the presidential choice, but we are certain that excessive regulation if it materializes could throw us into one. It's not hard to foresee a recession next year if Trump wins and immediately declares that our trade treaties are null and void, slaps tariffs on imports from China and Mexico, and penalizes U.S. companies that he views have exported jobs overseas. On the other hand, either one of them might not venture far from the status quo of the past several years, which has been a bullish environment for stocks.

**As was recently released by the FOMC, the Fed is in no rush to hike the federal funds rate again.** The committee decided to pass on a rate hike, though the statement indicated that the economy and labor markets are doing well, inflation is likely to move higher to the mandated 2% level reading "over the medium term as the transitory effects of past declines in energy and import prices dissipate and the near-term risks to the economic outlook have diminished."

**Our analysis of the federal funds rate since the early 50's shows that the Fed has on several occasions held off on raising this rate until after the presidential elections.** The same is likely to happen this year. However, a rate hike during the last meeting of the year is possible. If the "gradual" normalization of monetary policy means a 25 basis point increase once a year for the foreseeable future, then rates will remain unusually low for a while.

**Although the current bull market is aging, it's still putting up a great fight.** It started on March 6, 2009 on an intraday basis, when the S&P 500 touched 666, and as of July 31<sup>st</sup> closed up 218%. Not bad for a seven-year-old bull - and the recent drop in the 10-year Treasury bond yield was all we needed for the bull to charge ahead to new highs.

## **CLOSE-UP: The Economic Landscape**

---

**We expect August payrolls to be slightly below trend versus previous periods.** The probable reason is most likely due to seasonal adjustment factors. On closer examination of previous periods we have found that the initially-reported monthly nonfarm payroll gains for each of the last five years have disappointed median consensus estimates, by an average of 52k. Over the last dozen years, August nonfarm payrolls have surprised to the downside nine times, by an average of 46k according to our sources. For this reason, we have tempered our August payroll projections relative to the consensus forecasts of 180k for both headline and private-sector job gains. Our employment estimate is also consistent with one Fed rate hike this year, which, in our view, is more likely to come in December, after the U.S. presidential election. Despite the 250k-plus gains in employment over the last two months, the underlying pace of job growth is slowing. The year-over-year growth rate of nonfarm payrolls peaked in the current cycle at 2.3% in February 2015, and has since slowed to 1.7% as of July.

**A slower pace of hiring is entirely consistent with the historical performance of the labor market at the latter stages of the business cycle.** Typically, when the unemployment rate has approached 5%, the rate of job creation has slowed. The recent performance of the Institute for Supply Management (ISM) manufacturing survey is also telling us that employment growth could trend downward on a short term basis.

**We also expect that the ISM report could confirm the payroll report and show some seasonal weakness below 50 which is defined as back into contraction territory.** We would expect the details of the report not to reveal any segment to stand out materially and just reflect broad-based weakness in new orders, production, employment and inventories. While some forecasters, including the Chief Economist of the Institute for Supply Management, may be discounting the unusually large declines in the aforementioned series as an aberration, we believe the figures should be consistent with ongoing weakness in the factory sector. In fact, the Dallas, Kansas City, New York and Richmond PMIs were all negative last month. To be sure, the manufacturing sector only accounts for 8.5% of nonfarm payrolls.

**However, economists at Morgan Stanley point out that the 12-month trend in the manufacturing ISM has historically led the year-over-year growth rate of nonfarm payrolls by three months.** Over the past year, the ISM has averaged 50.2, the lowest reading over any 12-month period since February 2010, when the economy was just emerging from the Great Recession. Fed officials have already expressed concern about weak business spending. Thus, at minimum, the most recent manufacturing data could complicate monetary policymakers' desire to raise rates again, possibly as soon as the upcoming FOMC meeting.

**The good news is that the leading indicators continue to increase, with consumer expectations the only negative component.** Housing data in terms of housing starts advanced again by 2.1% in July to a 1.2 million pace and are up 5.6% y/y. Both existing home sales as well as new home sales are quite strong with the latter up 12.4% through July. Given the possibility of a sluggish economic backdrop before the next FOMC meeting, the bar might be raised a bit with respect to what the Fed needs to see in the employment report to feel confident enough to hike in September. A weak trend in the manufacturing ISM could point to deteriorating job growth.

**Keep in mind that capital spending has been a weak sector of the economy, primarily because of weak energy spending as a result of the dramatic fall in energy prices, and should be resolved over time as energy prices appear to be basing in the \$40-50 per barrel range.** Looking ahead, capital spending appears to be holding at current levels forming the base for future growth as we enter the second half of the year.

## **IN VIEW: Normalization of U.S. Interest Rate Policy supports Equity Valuations**

---

**Fed officials once again will gather at Jackson Hole at the highly anticipated annual event.** One issue that is likely to garner considerable attention during the symposium is the outlook for the neutral fed funds rate. Having fallen to – and remaining persistently near – record low levels, the neutral rate has drawn intensifying scrutiny from key Fed officials. Its outlook has pivotal implications for both the likely future path of the fed funds rate and the way in which monetary policy is conducted in the future.

**First, if U.S. real GDP growth averages about 2.0% as the Fed and most other forecasters expect, the real neutral fed funds rate is unlikely to rise significantly over at least the next several years.** It is also likely to remain below the Fed's long-term projection of 1% over this time frame. Consequently, a rising neutral rate is unlikely to be a key driving force for near-term rate increases, contrary to Fed forecasts and commentary. Fundamental to this conclusion is that the headwinds facing the U.S. economy persist for some time to come. These headwinds have included private sector deleveraging, periods of substantial fiscal drag, tight lending conditions particularly for mortgages, and more recently slow global growth and a rapid strengthening of the dollar. According to the Fed's narrative, these headwinds are likely to dissipate over time, allowing the neutral fed funds rate to rise.

**Over the longer-term, in the absence of shocks to the economy, the real neutral rate would likely approach the Fed's long-run estimate of 1% if economic growth remains around 2.0%.** But the high persistence of the neutral rate implies that the convergence toward 1% is likely to be very gradual, taking many years. If instead real GDP growth slows persistently below 1.5%, the real neutral rate is likely to remain stuck around 0%. At the same time, faster growth will see higher estimates for the neutral rate.

## IN SUMMARY:

---

**Economic conditions have improved only modestly, and yet credit conditions remain generally favorable.** During the first quarter, all the growth emanated from consumption and state and local spending, against a backdrop of weak capital and defense spending as well as international trade data. Since the end of the first quarter, consumption has strengthened further, housing has remained strong, and there are signs that manufacturing and industrial production have improved. At present, with both income and employment strong, we continue to forecast real GDP growth of 2.5% with CPI inflation of 1.7% and corporate profits approaching 5.0% for the year (or \$120 per share earnings for the S&P 500), assuming energy prices stabilize at current levels.

**While current valuation multiples are high at 17 times our estimate of 127 in earnings for the S&P 500 in 2017, they aren't excessive given record low bond yields.** Although we are generally supportive of market participation, returning mid-single digit returns for the foreseeable future, we recognize the current environment is a tough one for real earnings growth in excess of 5.0%.

**We are acutely aware that investors have never had to make decisions in the past with regards to global central bank policies of using monetary instruments to bring about negative interest rates. The U.S. has followed suit with a zero interest rate policy as well.** This monetary response to the financial crises of the great recession and resultant credit instability in many has disrupted historical pricing models for security valuations. As a result, both bond and equity markets have discounted much of the economic recovery. Throughout history, bond valuations have never been as high moving overall equity valuations back to fair valuation despite the anemic global growth recovery.

**However, we believe there still remain selective opportunities to invest in companies and industries that are mispriced by investors.** As the cycle matures, we continue to hold these securities while the overall economic environment sorts itself out. Keep in mind that when comparing earnings yields to bond yields stocks continue to look relatively undervalued.

---

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.