MORNING BRIEFING
August 9, 2017

Four Deuces Scenario

See the collection of the individual charts linked below.

(1) From three deuces to four of them. (2) You've got to know when to hold 'em, know when to fold 'em. (3) Misery Index falling along with jobless rate, leaving more room for P/E to rise and remain fairly valued. (4) The long good buy scenario. (5) Record job openings suggests economy at full employment. (6) Small business owners looking for help, but can't find qualified people. (7) The best or the worst of times? (8) Income stagnation is a big urban legend.

Strategy: Winning Hand. While real GDP growth continues to amble along at a leisurely pace of 2.0% y/y, the labor market is sprinting at a fast pace. In the 7/31 *Morning Briefing*, Debbie and I described our 2-2-2 economic scenario, with real GDP continuing to grow around 2.0% y/y, inflation remaining at or slightly below 2.0%, and the federal funds rate peaking late next year at 2.00%.

One of our accounts suggested expanding our Three Deuces scenario to Four Deuces (2-2-2-2) by adding the unemployment rate. The jobless rate was 4.3% during July and could fall to 2.0%, which would be the lowest on record starting in January 1948 (*Fig. 1*). The low for this series was 2.5% during May and June 1953. A new record low, even at 2.0%, is conceivable if the Three Deuces scenario continues to play out. That's because having slow economic growth with subdued inflation and low interest rates increases the odds of a very long economic expansion, with the labor market continuing to tighten.

That would be ideal for our "long good buy" scenario for the stock market, since bull markets usually don't end until the unemployment rate falls to its cyclical trough and starts moving higher (*Fig. 2*). The stock market also does well when the Misery Index, which is the sum of the unemployment rate and the inflation rate, is falling (*Fig. 3* and *Fig. 4*). Indeed, there is an inverse correlation between the Misery Index and the S&P 500 P/E since 1979 (*Fig. 5*). Consider the following:

(1) The sum of the forward P/E and the Misery Index has averaged 23.9 since 1979 (*Fig. 6*). It was 23.6 during June, suggesting that the stock market is fairly valued.

(2) A lower Misery Index, as a result of a further decline in the unemployment rate, would leave more room for P/E expansion without irrational exuberance. If the unemployment rate drops from 4.3% to 2.0% and the inflation rate remains at 2.0%, that would lower the Misery Index, leaving room for a reasonable increase in the forward P/E from 17.8 currently to 19.9 (since 19.9 + 4.0 = 23.9, which is the average of the Misery Index since 1979).

So, hold 'em, don't fold 'em because there is no reason to be miserable. As the song goes: Don't worry, be happy!

US Economy I: Help Wanted! Yesterday's releases of June's JOLTS report and July's NFIB survey of small business owners both confirm that the labor market is getting tighter and tighter, which means that the unemployment rate could continue to fall, which means less misery and higher stock prices, as we just explained above. Debbie reviews both releases in detail below. For now, let's consider a few of the reasons to be happy if you are looking for a job, but not so happy if you are looking for help:

(1) *JOLTS.* At the end of June, there were a record 6.2 job openings (*Fig. 7*). That month, there were 7.0 million unemployed. So the ratio of unemployed workers to job openings was 1.1, matching the low for this series in January 2001, which is one month after the start of this data. As we've noted before, this suggests that the economy is at full employment with only "frictional" unemployment resulting from geographic and skills mismatches.

Labor market activity remained brisk in June, with near recent cyclical highs in hires (5.4 million) and separations (5.2 million). Over the past 12 months through June, hires totaled 63.4 million, while separations totaled 61.1 million (including 3.1 million quits and 1.7 million layoffs) (*Fig. 8*). Given that payroll employment totals 146.6 million, that's an amazing amount of turnover in the labor force. (By the way, could it be that productivity suffers when there is too much turnover of workers?)

(2) *NFIB.* During July, 35.0% of small business owners reported that they had job openings (*Fig. 9*). That's the highest reading since November 2000. Most disturbing is that 52.0% reported that there are few or no qualified applicants for job openings.

There is a strong inverse correlation between the unemployment rate and the percentage of small business owners with job openings (on a three-month average basis) (*Fig. 10*). The latter suggests that the unemployment rate could easily fall to the 2000 low of 3.8%.

(3) *Wages.* Meanwhile, despite the tightness of the labor market, wage inflation remains subdued. While lots of small business owners report that they could use some help, average hourly earnings inflation remains around 2.5% y/y (*Fig. 11*). On the other hand, median wage inflation was 3.2% during June, suggesting that the Phillips Curve isn't completely flat (*Fig. 12*). I asked Melissa to look into why median wages are rising faster than average ones. Stay tuned.

US Economy II: The Best of Times. During the Great Depression, "Brother, Can You Spare a Dime?" was a song that resonated with the grim economic environment. The best-known versions, sung by Bing Crosby and Rudy Vallee, were released right before Franklin Delano Roosevelt's election to the presidency. It was an anthem to the shattered dreams following the Roaring '20s. Today, employers are singing, "Buddy can you spare some time?"

Yet, there remains lots of chatter about how the standard of living has stagnated for most Americans and income inequality has worsened. The implication is that if income inequality hadn't worsened, then the standard of living would have increased for more people. The rich have been getting richer, the narrative goes, while everyone else has suffered. The 1% must be bad, greedy people, and should be taxed to punish them, with their incomes redistributed for the greater good of the 99%. The government, of course, is Robin Hood.

How can the stock market possibly be doing so well when so many people are suffering from the effects of income stagnation? The stock market has clearly made lots of rich people richer, though lots of workers with corporate pensions and 401K plans invested in stocks are also benefitting. In any case, don't corporate earnings depend on a healthy economy with prosperity for all, not just a few? This seems to be yet another conundrum. Then again, the data belie the stagnation view, which therefore also challenges the worsening inequality thesis:

(1) *Income and consumption.* Progressives' favorite measure of income stagnation in the US is inflation-adjusted median money income per household (*Fig. 13*). It had a nice bounce in 2015, but it's back to where it was during 2000. That's 15 years of stagnation! Heads must roll! Not so fast,

Robespierre. Mean money income, which is higher than median, has also stagnated since 2000 even though it gives more weight to the filthy rich.

Lo and behold, real mean personal income per household, which is a much broader and more accurate measure of incomes, is up 25% from January 2000 through June 2017—to a record high. Is that all because rich people are getting paid much more and enjoying huge capital gains on their stocks and bonds? In the National Income Accounts, personal income excludes capital gains and losses. So are the rich getting paid a lot more now than 15 years ago?

I don't know, but I do know that real mean personal consumption per household is up 28% from January 2000 through June 2017 to a record high of $100,100 (saar). Surely, that can't be totally because of the rich stuffing their faces with gourmet meals and living the high life. There aren't enough of them to be having that impact on consumption, which is the most convincing evidence that the standard of living has increased broadly over the past 15 years, IMHO.

(2) *Wages.* More evidence is provided by the inflation-adjusted average hourly earnings of all production and nonsupervisory workers, which currently accounts for 70% of private payroll employment (*Fig. 14*). This measure of the real hourly wage rate is up 17% from January 2000 through June 2017. That's not stagnation. I presume that the rich are not classified as production and nonsupervisory workers. Other measures of real hourly compensation are up as much.

(3) *Piketty, et al.* This weekend, I am looking forward to reading a 7/6 working paper titled "Distributional National Accounts: Methods and Estimates for the United States," by Thomas Piketty, Emmanuel Saez, and Gabriel Zucman. This crew is renowned for data mining and finding lots of income stagnation and inequality. The abstract of their paper suggests that I won't be disappointed. It claims that the resourceful authors have found a way to "capture 100% of national income." Their punchline is:

"Average pre-tax real national income per adult has increased 60% since 1980, but we find that it has stagnated for the bottom 50% of the distribution at about $16,000 a year. The pre-tax income of the middle class—adults between the median and the 90th percentile—has grown 40% since 1980, faster than what tax and survey data suggest, due in particular to the rise of tax-exempt fringe benefits. Income has boomed at the top. The upsurge of top incomes was first a labor income phenomenon but has mostly been a capital income phenomenon since 2000."

CALENDARS

US. Wed: Productivity & Unit Labor Costs 0.8%/1.4%, Wholesale Trade Inventories 0.6%, MBA Mortgage Applications, EIA Petroleum Status Report, Evans. **Thurs:** Jobless Claims 241k, PPI-FD Headline, Core, and Core Less Trade Services 0.1%/0.2%/0.2%, Weekly Consumer Comfort Index, Treasury Budget, EIA Natural Gas, Dudley. (Bloomberg estimates)

Global. Wed: China CPI & PPI 1.5%/5.6% y/y, Japan Machine Tool Orders. **Thurs:** UK GDP 0.3%, UK Headline & Manufacturing Industrial Production -0.1%/0.7% y/y, China New Yuan Loans 790b, China Aggregate Financing 1,000b, China M2 9.4% y/y, Lowe. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—rose by 1.9% during the three weeks ending July 29, after falling six of the prior seven weeks by 3.6%; it's within 1.8% of its record high recorded 10 weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly

Consumer Comfort Index (WCCI). Our BBB climbed 2.2% over the three-week period, after contracting 4.5% over the prior seven-week period; it's 2.4% below its record high posted during the week of May 20. Jobless claims fell for the third week to 241,750 (4-wa) after rising from 235,500—which was the lowest since April 1973—to 246,000 the prior seven weeks. The CRB raw industrial spot price index—another BBB component—continued to move higher. Meanwhile, the WCCI climbed for the third week, by a total of 5.5%, after falling during five of the previous six weeks by a total of 8.2%.

S&P/Russell LargeCaps & SMidCaps (*link*): These LargeCap price indexes are back at record highs, but the SMidCaps have pulled back slightly from their late-July records. The SmallCap market-cap indexes have outperformed LargeCaps since the election, but MidCaps are trailing now. On a ytd basis, the LargeCaps are easily beating the SMidCaps. Here's the ytd score through Monday's close and their percentage changes since Election Day: S&P LargeCap 500 (10.8% ytd, 16.0% since the election), Russell LargeCap 1000 (10.6, 16.0), Russell MidCap (8.2, 14.5), S&P MidCap 400 (5.6, 15.8), Russell SmallCap (4.2, 18.3), and S&P SmallCap 600 (2.0, 17.7). Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, but the easy y/y comparisons may be waning. In the latest week, LargeCap's forward earnings improved to 9.7% y/y from 9.4% a week earlier, which compares to a 64-month high of 10.2% 13 weeks ago and a six-year low of -1.8% in October 2015; MidCap's surged to a 66-month high of 14.0% y/y from 13.0%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to a nine-week low of 12.0% from 12.6%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap and MidCap consensus growth rates expected for 2017 have been edging higher lately, leading to a slight decline in the 2018 growth rates. However, 2018 should improve if the corporate tax rate changes. Here are the latest consensus earnings growth rates: LargeCap 11.6% and 11.0%, MidCap 12.3% and 12.6%, and SmallCap 8.9% and 18.8%.

S&P 500 Growth vs. Value (*link*): The S&P 500 Growth index is up 15.9% ytd, well ahead of the 5.0% gain for its Value counterpart. Growth had trailed Value in the four months following the election. Now, Growth's 18.1% gain since the election is leading the 13.0% increase for Value. During 2016, the S&P 500 Growth index underperformed its Value counterpart by a wide margin, rising just 5.1% vs Value's 14.3% gain. Growth is expected to deliver higher forward revenue growth (STRG), but lower forward earnings growth (STEG), than Value over the next 12 months: 7.3% STRG and 10.7% STEG for Growth, respectively, vs 4.1% and 10.9% for Value. Growth's P/E of 20.5 is the highest since February 2004, while Value's 15.5 is down from early March's 14-year high of 16.2. Regarding NERI, Growth's was positive in July for a third month as it edged down to 7.9% from a six-year high of 8.0% in June; that compares to a five-year low of -16.2% in April 2015. Value's NERI was also positive in July for a third month, following 33 months of negative readings, but dropped to 3.8% from a six-year high of 4.7%; that compares to a five-year low of -20.3% in April 2015.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index (*link*): "Main Street was buoyed by stronger customer demand despite the dysfunction in Washington D.C.," according to NFIB. The Small Business Optimism Index (SBOI) jumped 1.6 points in July to 105.2—after drifting down from January's cyclical high of 105.9 to 103.6 by June—preserving the surge in optimism that started the day after the election. July's reading is within striking distance of a new cyclical high and 10.3 points above its reading of 94.9 just before the November election. Seven of the 10 index components contributed to July's rebound, with the biggest contributions coming from sales expectations (to 22% from 17%), job openings (35 from 30), job creation (19 from 15) and better business conditions (37 from 33), with both employment measures more than reversing June's declines, climbing to new cyclical highs. Capital spending plans (28 from 30) and expected credit conditions (-4 from -3) were the only drags on the SBOI, while earnings trends was unchanged at -10%.

JOLTS (*link*): Job openings rose for the fifth time this year, jumping 461,000 in June and 624,000 ytd to a new record high of 6.163 million. Hirings dipped 103,000 to 5.356 million after rebounding by 416,000 in May—which was the biggest monthly gain since March 2004. Separations slipped 21,000 to 5.224 million after climbing 237,000 in May. The latest hirings and separations data yielded an employment advance of 132,000 for June, 99,000 below June's payroll gain of 231,000—coming in below payroll employment for the second time in three months. June's job-opening rate was back at its record high of 4.3%, while the total hires rate (4.1%) was just below its cyclical high of 4.2%; the quit rate (2.4) ticked down from May's cyclical high of 2.5%. The ratio of unemployed workers per job opening (1.13) sank back to its record low in January 2001; it had peaked at 6.65 during July 2009.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators (*link*): In June, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—once again pointed to stable growth momentum in the OECD (100.0) as a whole, however, there were changes in some major economies. While CLIs for the Eurozone (100.4), Japan (100.2), and Canada (100.5) continued to show stable growth momentum, June's CLI for the UK (99.6) confirmed the tentative signs of easing growth flagged in May's assessment, while CLIs for the US (99.7) and Italy (100.1) were upgraded from easing growth momentum to stable growth momentum. Prospects of growth gaining momentum remained unchanged for Germany (100.9) and France (100.7), as well as for China (100.0) and Brazil (102.4). As for India (99.5) and Russia (100.9), the CLI for the former continued to point to stable growth momentum, while tentative signs of easing growth remained for the latter.

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