MORNING BRIEFING
July 8, 2019

Another Powell Pivot Ahead?

See the collection of the individual charts linked below.

(1) Neither weak demand nor dwindling supply in labor market, so far. (2) In our best-case scenario, productivity offsets labor shortages. (3) Labor force growth slows to a trickle. (4) Productivity growth collapsed during the Great Inflation and Great Recession. (5) The case for better real pay gains. (6) Good for consumers: Earned Income Proxy at record high. (7) Is a Fed rate cut still appropriate? (8) Will Powell pivot again?

US Labor Market: Will Productivity Offset Labor Shortages? Last month, Debbie and I argued that May's weak payroll gain of 75,000 was likely an aberration. We certainly didn't believe that labor demand is weakening given that so many other labor-market indicators remained robust. If the weak number reflected anything fundamental in nature, it might have been a sign that a shortage of workers might be the problem. Friday's employment report, showing a solid payroll gain of 224,000 during June, put both the weak-demand and worker-shortage theses on ice. It probably froze monetary policy in place as well, for now, as discussed in the next section.

Then again, a closer look at the latest data in the context of the past 12 months shows some signs of labor-market fatigue on both the demand side and the supply side. Of course, the two sides of this market are not independent. It's conceivable that after struggling to find the right workers with the right skills in the right geographical locations, some employers are giving up.

That could be bad news for economic growth. Or it could be good news if employers are finding ways to increase the productivity of their current workforce. A secular upturn in productivity remains our working hypothesis to explain how the longest expansion in US economic history might continue apace despite labor shortages.

In our best-case scenario for the economy, the slowing pace of labor-force growth should be offset by a pickup in productivity growth. Since productivity growth drives the growth in the inflation-adjusted wage rate, consumer spending should be bolstered by real wage gains, offsetting the slowdown in supply-constrained payrolls. Let's have a closer look at the data that we will be monitoring to track whether our upbeat outlook is panning out:

(1) *12-month trends.* Over the past 12 months through June, payroll employment rose 191,800 on average (*Fig. 1*). That's certainly a solid performance, though it is the slowest pace since last April. The average for the last three months was weaker at 170,700. The supply constraints may be showing up in the 12-month average increase in the labor force, which was only 71,000 through June, near the bottom of the range since 2017 (*Fig. 2*).

(2) *10-year trends.* The constraint on economic growth attributable to labor shortages can be seen more clearly by tracking the average 10-year annualized growth rates of both the working population aged 16-64 years old and the labor force (*Fig. 3* and *Fig. 4*). The former was just 0.4% through June,

the lowest on record, while the latter was only 0.3%, near the record lows of the past couple of years.

(3) *Productivity & real GDP*. It is instructive to compare the average annualized growth rate of the labor force over the past 10 years to real GDP's comparable growth rate (*Fig. 5*). The secular growth rate of the labor force certainly has an influence on the trend growth in real GDP. The former fell from a record high of 3.1% during the 10-year period through January 1979 to only 0.5% through June of this year. That has weighed on the growth rate of real GDP, but productivity growth allowed the economy to more than offset the slowdown in the supply of labor over this period (*Fig. 6*).

Productivity growth collapsed during the Great Inflation of the 1970s and during the Great Recession of 2008 and for several years after this event. The productivity growth cycle may be turning. Productivity hit a low of 1.2% during the 10-year period through Q4-2017. It was up to 1.4% during Q1-2019. Using the five-year growth rate puts the bottom at only 0.5% during Q4-2015, with an increase to 1.3% by Q1-2019.

(4) *Better growth in real wages ahead.* Our upbeat outlook for productivity should boost the growth rate of real hourly compensation (RHC). Naysayers have observed that since the mid-1970s there has been a growing divergence between productivity and RHC (*Fig. 7*). That divergence is mostly attributable to the fact that for some bizarre reason the Bureau of Labor Statistics still uses the CPI to deflate the hourly compensation series, which is released along with productivity.

Much of the divergence disappears when RHC is calculated using the personal consumption expenditures deflator (RHC-PCED). Almost all of the gap between productivity and RHC is eliminated using the nonfarm business deflator (RHC-NFBD). That makes sense since microeconomic theory says that employers pay their workers the real value of their marginal product based on the prices that employers receive for the goods and services that they produce rather than on prices that consumers pay!

The 10-year growth rates of both the RHC-PCED and RHC-NFBD continue to be highly correlated with the comparable growth rate in productivity (*Fig. 8*). If productivity growth has started to rebound over the past few years and continues to do so, then so should the growth rate in RHC-PCED!

(5) *Signs of strength.* For the here and now, our Earned Income Proxy (EIP) for private-sector wages and salaries rose 0.4% m/m and 4.6% y/y during June (*Fig. 9*). Over this period, aggregate weekly hours worked is up 1.5%, while average hourly earnings is up 3.1%. Both components of the EIP are at record highs. Also looking upbeat are the latest surveys of job openings, showing plenty of them.

(6) *Signs of weakness.* If you are looking for trouble, the four-week average of initial unemployment claims rose to 222,300 through the 6/29 week, up from a recent low of 201,500 during the 4/13 week (*Fig. 10*). However, you really need to use a magnifying glass to see trouble in this important labor-market indicator. Last week, we noted that the jobs-hard-to-get response in June's survey of consumer confidence rose to 16.4% from a recent low of 11.8% during May. That may be a sign that labor demand is weakening, or (more likely, in our opinion) that the remaining supply of workers isn't qualified for the available jobs.

Somewhat more worrisome, in our opinion, is that ADP's count of private-sector payrolls rose only 102,000 during June following a gain of just 41,000 during May (*Fig. 11*). Goods-producing payrolls dropped slightly during the past two months. The same can be said for small companies with 1-49 employees (*Fig. 12*).

The Fed: What's 'Appropriate' Now? In our 6/24 Morning Briefing, Melissa and I wrote: "We aren't convinced that a rate cut at the July FOMC meeting is as likely as many traders believe." After Friday's stronger-than-expected jobs report, we are surprised that a rate cut is still widely expected, though instead of a 50bps cut, now 25bps is the consensus. Stock prices fell modestly on Friday on that revised outlook for the federal funds rate.

We still expect no rate cut. If we are right, that could put more downward pressure on stock prices this month, especially since this month's corporate earnings reporting season is likely to show that earnings were basically flat on a y/y basis during Q2-2019, as they were during Q1.

Given June's solid employment gain, the indefinite truce in the US-China trade war, and the record high in the S&P 500, we don't see that a rate cut is necessary or justifiable. Fed Chair Jerome Powell seems to be pivoting more often these days. We expect he will do so again when he testifies before Congress on monetary policy this week on Wednesday and Thursday.

The Fed's latest *Monetary Policy Report* to Congress was released on Friday. It noted that during most of the first half of 2019, the FOMC "indicated that, in light of global economic and financial developments and muted inflation pressures, it would be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate. At the June FOMC meeting, however, the Committee noted that uncertainties about the global and domestic economic outlook had increased. In light of these uncertainties and muted inflation pressures, the Committee indicated that it will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective."

We will soon find out from Powell how he and his colleagues currently define "appropriate." Tomorrow, we will turn to a retrospective of the Fed's word games.

CALENDARS

US. Mon: Consumer Credit $16.9b. **Tues:** Job Openings 7.473m, NFIB Small Business Optimism Index 103.1, Bullard. (DailyFX estimates)

Global. Mon: Eurozone Sentix Investor Confidence 0.2, Germany Industrial Production 0.3%m/m/-3.2%y/y, Kuroda. **Tues:** China New Yuan Loans ¥1675b, China Aggregate Financing ¥1900b, Japan Machine Tool Orders, Mexico CPI 3.95% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance (*link*): Last week saw the US MSCI index rise 1.7% and finish 0.2% below its record high on Thursday. The AC World ex-US rose 0.5% for the week to 12.4% below its record high in January 2018. The US MSCI's weekly performance ranked 12th among the 49 global stock markets we follow in a week when 33/49 countries rose in US dollar terms. That compares to the prior week's 39/49 ranking, when the US MSCI fell 0.3% as 32 markets rose. EM Latin America was the best performing region last week with a gain of 2.3%, followed by BRIC (1.3%), EMEA (1.0), and EM Eastern Europe (0.7). The regions underperforming last week: EMU (0.1), EM Asia (0.3), and EAFE (0.5). Turkey was the best-performing country with a gain of 7.0%, followed by Sri Lanka (4.8), Pakistan (3.4), Brazil (3.0), Peru (2.5), and Hong Kong (2.5). Of the 21 countries that underperformed the AC World ex-US MSCI last week, the Czech Republic fared the worst, falling 2.9%, followed by Korea (-2.5), Portugal (-1.5), and South Africa (-1.5). The US MSCI's ytd ranking rose two places last week to 8/49, with its 19.6% ytd gain still well ahead of that of the AC World ex-US (12.2). All regions and 44/49 countries are in positive territory ytd. Nearly all the regions are outperforming the AC World ex-US ytd: EM Eastern Europe (20.7), BRIC (13.8), EMU (13.7), EM Latin America (13.4), EMEA (13.3), and

EAFE (12.3). EM Asia (8.9) is the sole laggard. The best country performers ytd: Greece (31.8), Russia (30.0), Argentina (28.6), Egypt (22.7), and Colombia (21.0). The worst-performing countries so far in 2019: Pakistan (-14.0), Sri Lanka (-5.2), Chile (-4.0), Jordan (-2.2), and Morocco (-1.7).

S&P 1500/500/400/600 Performance (*link*): The LargeCap index rose for the fourth time in five weeks, while MidCap and SmallCap posted their fifth weekly gain in a row. LargeCap's 1.7% gain outpaced the 1.1% increase for MidCap and the 0.5% rise for SmallCap. LargeCap ended the week 0.2% below its record high on Thursday, and MidCap improved to 4.1% below its 8/29 record high. SmallCap remained in a correction at 12.7% below its 8/29 record after narrowly averting a bear market at the end of May. Twenty-seven of the 33 sectors moved higher last week compared to 19 rising a week earlier. Last week's best performers: SmallCap Communication Services (4.2%), MidCap Communication Services (4.0), LargeCap Communication Services (2.7), LargeCap Real Estate (2.4), and MidCap Real estate (2.4). SmallCap Energy (-3.2) was the biggest decliner, followed by MidCap Energy (-3.0), LargeCap Energy (-0.9), SmallCap Materials (-0.1), and MidCap Materials (-0.1). In terms of 2019's ytd performance, all three indexes are still off to a healthy start for the year. LargeCap leads with a gain of 19.3% ytd, slightly ahead of MidCap (18.2) and well ahead of SmallCap (13.4). Thirty-one of the 33 sectors are positive ytd, with the cyclicals leading the top performers: LargeCap Tech (28.9), MidCap Tech (28.5), LargeCap Consumer Discretionary (23.5), MidCap Industrials (23.4), and LargeCap Communication Services (21.6). MidCap Energy (-3.4) is the biggest decliner so far in 2019, followed by these underperformers: SmallCap Energy (-0.6), SmallCap Consumer Staples (5.2), SmallCap Communication Services (7.1), and MidCap Consumer Staples (7.3).

S&P 500 Sectors and Industries Performance (*link*): Ten of the 11 S&P 500 sectors rose last week as six outperformed the S&P 500's 1.7% rise. That compares to four rising a week earlier, when five outperformed the S&P 500's 0.3% decline. Communication Services was the best-performing sector, with a gain of 2.7%, ahead of Real Estate (2.4%), Information Technology (2.2), Consumer Staples (2.2), Consumer Discretionary (2.1), and Financials (1.9). Last week's biggest underperformers: Energy (-0.9), Industrials (0.1), Materials (0.5), Health Care (1.2), and Utilities (1.6). All 11 sectors are higher so far in 2019, compared to just two sectors rising during 2018, when the S&P 500 fell 6.3%. These five sectors have outperformed the S&P 500's 19.3% rise ytd: Information Technology (28.9), Consumer Discretionary (23.5), Communication Services (21.6), Real Estate (21.4), and Industrials (20.3). The ytd laggards: Health Care (8.4), Energy (10.1), Utilities (14.6), Materials (16.6), Consumer Staples (17.0), and Financials (18.2).

Commodities Performance (*link*): Last week, the S&P GSCI index fell 0.7% as 10 of the 24 commodities moved higher. That compares to 17 rising a week earlier when the index rose 1.0%. The index had nearly climbed out of a correction during mid-April, with a drop of just 10.0% from its high in early October after being down as much as 26.9% from that high on 12/24. It's now 16.0% below its October high. Natural Gas was the strongest performer for the week, as it rose 4.8%, ahead of Corn (3.3%), Live Cattle (2.5), Unleaded Gasoline (1.7), and Cocoa (1.6). Zinc was the biggest decliner, with a drop of 3.9%, followed by Kansas Wheat (-3.5), Lead (-3.3), and Soybeans (-3.1). The S&P GSCI commodities index is up 12.8% ytd following a decline of 15.4% in 2018. The top-performing commodities so far in 2019: Unleaded Gasoline (48.2), Crude Oil (26.6), Lean Hogs (26.4), Brent Crude (19.4), and Corn (17.0). The biggest laggards in 2019: Natural Gas (-17.8), Live Cattle (-13.6), Kansas Wheat (-8.9), Lead (-7.7), and Cotton (-7.5).

S&P 500 Technical Indicators (*link*): The S&P 500 price index rose 1.7% last week as it continued its successful test of its short-term 50-day moving average (50-dma) and its long-term 200-day moving average (200-dma) at the end of May. The index's 50-dma relative to its 200-dma rose for 20th time in 21 weeks to a 15-month high, forming a Golden Cross for a 15th week after 16 weeks in a Death Cross formation. The index had been in a Golden Cross for 137 weeks through late November, and its previous Death Cross lasted for 17 weeks through April 2016 (when its 50-dma bottomed at a then-four-year low of 4.5% below its 200-dma in March 2016). The current Golden Cross reading of 4.2% is up from -5.2% in early February, which had matched the lowest reading since November 2011. It's still down from a 55-month high of 7.2% in February 2018. The S&P 500's 50-dma rose at a faster rate, with the price index rising to a 12-week high of 3.7% above its 50-dma from 2.2% above a week earlier. That's up from a 22-week low of 4.2% below its falling 50-dma at the end of May, but down from 6.6% above during mid-February, which was its highest since October 2011. The 200-dma rose for a fourth week following three straight declines. It had been rising for 16 weeks through mid-May after falling from October to February in the first downtrend since May 2016 (when it had been slowly declining for nine months). The index traded above its 200-dma for a fifth week to a 16-month high of 8.0% above its rising 200-dma from 6.3% a week earlier. That compares to 14.5% below its falling 200-dma on 12/24, which was the lowest since April 2009 and remains well below the seven-year high of 13.5% above its rising 200-dma during January 2018.

S&P 500 Sectors Technical Indicators (*link*): All 11 S&P 500 sectors traded above their 50-dmas for a third week and for the first time since early April, unchanged from a week earlier. All 11 were last below in early January. The longer-term picture—i.e., relative to 200-dmas—shows 10 sectors trading above currently, unchanged from a week earlier, as Energy was below its 200-dma for a 39th week. Ten sectors are in the Golden Cross club (with 50-dmas higher than 200-dmas), up from nine a week earlier and matching the highest count since January 2018 when all 11 sectors were in the club. Health Care moved back into the Golden Cross club after being out for nine weeks and Financials has been back in for just 10 weeks. The sole laggard, Energy, has been out for 34 straight weeks. Just three sectors still have falling 50-dmas now, unchanged from a week earlier. Energy's 50-dma fell for a tenth week, while Industrials and Materials have been mostly falling for the past seven weeks. Eight sectors have rising 200-dmas, up from six a week earlier, as Financials and Materials turned up after mostly falling for more than eight months. Among the laggards, Energy has had mostly falling 200-dmas for more than eight months, Health Care since mid-April, and Industrials since mid-May. That compares to just two sectors with rising 200-dmas in early January, in what was then the lowest count since all 11 sectors had falling 200-dmas two years before.

US ECONOMIC INDICATORS

Employment (*link*): Hirings bounced back in June, though there were slight downward revisions to the prior two months. Payroll employment climbed at a five-month high of 224,000 last month, following gains of 72,000 (from 75,000) in May and 216,000 (224,000) in April, for a net loss of 11,000. Private payrolls added 191,000 jobs in June—89,000 above the ADP number of 102,000—after rising 83,000 (from 90,000) in May and 195,000 (205,000) in April, for a net loss of 17,000. June's gain was led by professional & business services, which added 51,000 jobs last month (above the 35,000 average monthly gain during H1) and 482,000 over the past 12 months. Health care also continued to trend higher, boosting payrolls by 35,000 m/m and 403,000 y/y. After a weak May, construction companies hired 21,000 last month, in line with the average gain over the past 12 months. Manufacturing jobs were also back on track, boosting June payrolls by 17,000—after a three-month gain of only 3,000. Employment in other major industries—including mining, wholesale trade, retail trade, information, financial activities, leisure & hospitality, and government—showed little change over the month. The breadth of job creation (i.e., the percentage of private industries increasing payrolls) shows the one-month span (60.7%) moved back above 60.0%, while the three-month span (63.6) moved further above 60.0%.

ADP Employment (*link*): Private industries added only 102,000 to payrolls in June, following May's 41,000 count—which was the smallest since March 2010. "The job market continues to throttle back. Job growth has slowed sharply in recent months, as businesses have turned more cautious in their hiring. Small businesses are the most nervous, especially in the construction sector and at bricks-and-mortar retailers," according to the report. In June, service-providing industries added 117,000 jobs after hiring only 65,000 in May—the smallest two-month tally since October 2017. Goods-producing industries cut jobs for the second month, by 15,000 in June and 24,000 in May—led by a 41,000 drop in construction jobs over the two-month period. Large companies (65,000), which are better equipped to compete for labor in a tight labor market, posted the best job growth again last month, while small businesses (-23,000) cut payrolls for the second straight month. Meanwhile, medium-sized companies added 60,000 jobs last month, five times May's 12,000—which was the smallest in over nine years.

Earned Income Proxy (*link*): Our Earned Income Proxy (EIP), which tracks consumer incomes and spending closely, continued to set new highs in June—not posting a decline since February 2016. Our EIP rose 0.4% last month, matching May's gain; it was 4.6% above a year ago. Average hourly earnings (AHE), one of the components of our EIP, rose 0.2% last month, and 3.1% y/y, slowing from 3.4% in February—which was the highest since April 2009. Meanwhile, aggregate weekly hours—the other component of our EIP—rose 0.2%, up from 0.1% in May; it was up 1.5% y/y, slowing from 2.4% at the start of this year.

Unemployment (*link*): The unemployment rate in June edged slightly higher, reflecting an influx of people seeking jobs who were initially counted as unemployed. The rate ticked up to 3.7% from 3.6% the prior two months—which was the lowest rate since December 1969; the participation rate moved up from 62.8% to 62.9%. The adult unemployment rate held at 3.3% last month after falling to 3.2% in April—which was the lowest since January 1970—while the college-grad rate (2.1%) remained a tick above its cyclical low of 2.0%. The volatile teenage rate (12.7) has fluctuated around 13.0% the first six months of this year, after falling to a cyclical low of 12.0% during October and November. The number of workers working part-time for economic reasons (a.k.a. "involuntary part-time workers") fell 307,000 during the two months ending June to 4.3 million (2.7% of the civilian labor force), after climbing 344,000 during the two months through April. The sum of the underemployment and jobless rates edged up from 6.3% to 6.4% last month, while the U6 rate, which includes marginally attached workers, inched up to 7.2% after dropping to 7.1% in May. The May rates for both measures were the lowest since December 2000.

Wages (*link*): June wages—as measured by AHE for all workers on private nonfarm payrolls—climbed to another new record high, edging up 0.2% for the month. The wage rate remained at 3.1% y/y, slightly below February's 3.4%, which was the highest rate since April 2009; it was at a recent low of 2.3% during October 2017. The wage rate for service-providing industries (3.2% y/y) has eased from its series high of 3.6% recorded in February, while the goods-producing rate (2.7) continued to fluctuate in a flat trend between 2.0%-3.0%. Within goods-producing, the manufacturing rate (2.3) is on a modest uptrend, while construction's (3.2) continues to hold just above 3.0%; the natural resources (3.5) rate remains on an accelerating trend, though dipped a bit in June. Within service-providing, rates for both retail trade (4.4) and information services (5.0) are down from their series highs of 5.0% and 6.6%, respectively, though the former did tick up in June, while the rate for wholesale trade (3.0) has eased for the third month since reaching a cyclical high of 3.9% in March. The rates for leisure & hospitality (3.8) and transportation & warehousing (1.9) remain on accelerating trends. The rate for financial activities (3.7) appears to have found a bottom, while rates for utilities (4.0) and professional & business services (3.1) are stalled around recent highs.

Merchandise Trade *(link*): The real merchandise trade deficit widened dramatically in May, suggesting trade was likely a drag on Q2 GDP growth. Since reaching a record gap of -$91.2 billion at the end of last year, the deficit narrowed during three of the first four months of this year to -$82.2 billion in April; it widened to -$87.0 billion in May. The April/May average monthly gap of -$84.6 billion is steeper than Q1's average monthly deficit of -$82.7 billion. In May, both real exports (3.1%) and real imports (4.1) increased, though imports rose at a faster pace than exports, widening the deficit. May's advance in both real exports and imports was widespread. Here's a look at exports: food (8.0%), autos (4.8), consumer goods ex autos (4.8), and capital goods ex autos (3.0) all in the plus column, with consumer goods ex autos reaching a new record high. Exports of industrial supplies & materials (-0.2) were little changed. Autos (7.6) posted the strongest growth among imports—jumping to a new record high, while industrial supplies & materials (4.4), capital goods ex autos (3.0) and consumer goods ex autos (2.6) also recorded impressive gains; food imports ticked up 0.3% in May. The export categories showing ytd gains are food (26.5%, ytd), autos (9.9), and consumer goods ex autos (4.9); for imports autos (4.5) and consumer goods ex autos (0.5).

GLOBAL ECONOMIC INDICATORS

Eurozone Retail Sales (*link*): Retail sales in May fell for the second time this year, following a strong showing at the start of the year. Sales contracted 0.3% after falling a revised 0.1% (from -0.4%) in April; sales expanded 1.6% the first three months of the year to a new record high. Sales of food, drinks & tobacco sank 0.7% during the two months ending May, reversing the 0.7% gain posted during the two months ending March. Non-food products (excluding fuel) soared 2.8% the first two months of this year to a new record high, and remained within 0.4% of that level the next three months. Meanwhile, automotive fuel sales fell for the fourth consecutive month in May, by 1.3% m/m and 2.6% over the period. May sales are available for three of the four largest Eurozone economies: Sales in France have increased four of the past five months, by 0.4% in May and 2.0% over the period to a new record high, while Spain's followed suit, expanding 1.1% and 2.0% over the comparable periods. German sales slumped 1.7% during the two months through May after a three-month spurt of 3.6%.

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