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Fed Provides More Liquidity; Phase 1 Trade Deal, But No Corroboration On Jobs Report

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Much has happened economically in the past couple of weeks including the Fed's communication that it does not expect any rate actions in 2020, a Conservative Party sweep in the UK (which pays well in the U.S. for free marketeers), and a supposed "Phase 1" trade pact, although there won't be a signed document until sometime in January (still time for Lucy to pull the football away – again!).

The Fed

No rate hikes in 2020. Markets, of course, like easy money and low interest rates. Since Alan Greenspan's ascension to the Chair role in 1987, the Fed has proven time and again that they can actually engineer inflation. The trouble is, the inflation they engineer is asset inflation, while their goal is to produce inflation in the prices of goods and services. More important than the "no 2020 rate hikes" was the promise to fund $490 billion in the repo market going into year's end. Yes, you saw that correctly; $490 billion.

While they don't call this QE, it has the same impact, as it bloats their balance sheet and puts a significant amount of reserves in the banking system. Banks, of course, will invest such reserves. Since loan demand is rather weak, most of the money will find its way into the Treasury market, meaning there will be downward pressure on interest rates, especially short-term ones, going into year end. If I remember correctly, in 2018, the Fed was reducing its balance sheet by $20-$50 billion/month (called QT), and that caused a 20% downdraft in equity prices about a year ago. Compare that to the promised $490 billion. How can stock prices not rise?

Still, one should ask why the Fed would signal no rate increases and bloat up its balance sheet unless it doesn't see accelerating economic growth or a return of any consumer price inflation anytime soon. Regarding growth, if it isn't accelerating, then it is either in neutral (which the Fed hopes) or is decelerating (which the data signal).

The Fed still admits in its post-meeting statement that there are still more risks to the downside than to the upside. And that, clearly, is what bond investors see, as, even with the most optimistic growth scenario suggested by the recent headline employment numbers, the yield on the 10-year T-Note couldn't close above 1.9%.

The Innovative Titan: How Large, Established Companies Can Out-Think Startups

Phase 1

From what can be gleaned from non-detailed disclosures on the part of both sides, the Phase 1 trade deal with China removed some, not all, of the existing tariffs, as it left in place 25% tariffs on $250 billion of Chinese goods. According to the President, such tariffs are "negotiating" tactics for Phase 2. It does appear that there were some promises on the part of the Chinese to purchase more U.S. goods. But, we've seen this before, and, somehow, those purchases never materialize. The agreement does cancel the tariffs that were scheduled to go into effect on December 15th, but that just cancels future pain. So, while some uncertainty may be eased, much of it remains. Don't forget this President's penchant to use tariffs for leverage, and the very real possibility that they may be reasserted. So, while the agreement might ease tensions somewhat, it doesn't look like it will do much for U.S. economic growth.

No Corroboration

After denying for months that the U.S. economy was slowing, Wall Street quickly adopted the position that "the slowdown we've been seeing these past months has now apparently passed" with the release of the +266K Establishment Survey employment report on December 6th. It has been a week, and, so far, I can't find any corroborating evidence. It appears that the +266K number is the outlier:

- The ADP report, done by a payroll processing company, only showed employment growth of +67K for November. In addition, ADP's report indicated that small businesses shed -19K (and -79K since April).
- In the Establishment Survey for November, the Birth/Death model, an algorithmic substitute for net new small business formation, added +60K to the total. Remember, these are not actually counted, just plugged in. The fact that we know that ADP has been seeing declining small business employment for most of the year should call into question the use of the Birth/Death model. Perhaps BLS should actually survey the small business community.
- The BLS does two side by side employment surveys each month, one of large and medium sized companies (the Establishment or Payroll Survey), and one of individual households (the Household Survey). The media pays

no attention to the Household Survey, albeit that is the Survey that determines the official Unemployment Rate(s), the U3 (3.5%) and U6 (6.8%) being the most quoted.

- The Household Survey indicated net new jobs were +83K, of which only +17K were full-time jobs. ADP only surveys the "private sector," and excludes government. So, it would appear that, because the Household Survey includes government jobs, ADP and the Household Survey corroborate each other.

- It also should be noted that First time Unemployment Claims spiked up by +49K in the week ending December 7th to +252,000. First Time Claims appear to have been dancing around record low levels for the past year or two, and analysts point to these as a reason why the labor market is tight (but, no one can figure out why wages won't rise in this "tight" market). Coincidentally, over the past year or so, states have tightened up the rules and enforcement of the rules to claimants of unemployment benefits. As a result, such new enforcement has reduced new claims; perhaps an explanation why this series looked to be at record lows but wages weren't rising. On the other hand, a spike in this series, especially such a large one i.e., +49K, is an indication that layoffs are truly in progress. Again, another piece of non-corroborating evidence for the Establishment Survey.

- The November employment report for Canada was -71K, of which -38K were full-time jobs. According to Wall Street economist David Rosenberg, it is quite a rarity for there to be such a disparity. Using three decades of data, Rosenberg says there is a 94% correlation between Canadian and U.S. employment surveys. So, the Canadian data are clearly at odds with the +266K Establishment Survey number.

It is pretty clear that the Establishment Survey is the outlier.

2020 Profits and P/E Ratios

The table shows the trailing and forward P/E ratios for the S&P 500 as they stood on 12/31/18 and on 12/10/19. The latest ratios are quite high. Because corporate profits have actually fallen throughout 2019 (-0.3% Q1, -0.4% Q2, -2.2% Q3 and analysts expect -3.6% Q4), more than 100% of the S&P 500's 26%+ gains for the year have come from rising P/E ratio.

P/E	12/31/18	12/10/19
Trailing	16.5x	20.9x
Forward	14.5x	17.8x

If you believe in mean reversion, then this table ought to scare you. You have to believe that profits for 2020 will be very strong, even in the face of rather meek initial reports from 2019 holiday retail, individual reports of stagnant sales from

the luxury retailers like Tiffany, or negative same store sales from traditional retailers like Saks (-2.3%). Analysts earnings for S&P 500 companies for 2020 have been declining. They now stand at +9.8%. But remember, they were +11.8% for 2019 at this time last year and look at what actually happened.

Clearly the bond market isn't buying into a "significant" rise in corporate profits for next year. If it were, the yield on the 10-year T-Note would be a lot higher than 1.82%!

Conclusions

The Fed will liquify the markets, at least through year's end. Unless the "trade" deal collapses, which now seems a remote possibility (at least until sometime in January), the equity market will continue to be supported. With all of the bank reserves being created, there should also be a strong bid for bonds.

Next year, it does appear that manufacturing weakness will continue; the Phase 1 trade deal, while it might benefit U.S. farmers, is unlikely to bring immediate relief to manufacturers. The early retail reports for the holidays indicate a more cautious consumer with November retail sales flat (Cyber Monday was in December and wasn't counted). Credit card debt is high. Consumers could tighten the purse strings; even just a bit likely means zero growth. If that's the case, the +9.8% corporate profit forecast for 2020 will likely come way down. Will the market? Can P/E ratios rise even more?

About the Contributor

Robert Barone, Ph.D. is a Georgetown educated economist. He is a financial advisor at Four Star Wealth Advisors: www.fourstarwealth.com. He is nationally known for his writings and Robert's storied career includes his having served as a Professor of Finance, a community bank CEO, and a Director and Chairman of the Federal Home Loan Bank of San Francisco. Robert is currently a Director of CSAA Insurance Company (the AAA brand) where he chairs the Finance and Investment Committee. Robert is the co-portfolio manager of the UVA Unconstrained Medium-Term Fixed Income ETF (FFIU).