Thursday, April 14, 2016

SEASONAL DISTORTIONS

- US GDP growth for the first quarter of previous calendar years has been routinely distorted to the downside; still GDP growth for Q1 2016 was, at best, stagnant.
- Currently, a better metric than GDP for US economic growth is jobs growth, which is robust and continues to improve.
- The Federal Reserve is putting itself in a position where it may have to raise rates quickly when it does begin a tightening cycle. This has implications for a stronger dollar, which has implications for the economy.
- Oil price stabilization, even at these higher levels, will help improve overall stock market profits by improving margins for Energy companies.

"Due to a 'seasonal distortion,' real GDP (Gross Domestic Product) over the past two decades has tended to slow markedly in the first quarter, while also accelerating in the second quarter. The three weakest first quarters in this expansion to-date were -1.5% in 2011, -0.9% in 2014 and +0.6% in 2015. They were followed by +2.9%, +4.6% and +3.9% in the second quarters, respectively. The pattern will perhaps repeat again this year." – Liz Ann Sonders, Chief Investment Strategist at Charles Schwab

Measuring a $17 trillion economy isn't easy. The reporting is lagged and revised, literally, for years. But details of seasonal distortions aside, GDP growth came to a near standstill last quarter. ***Job growth, however, remains robust, with no sign of slowing. The job numbers are a better representation of the reality of the economy's performance and near-term prospects.***

The keepers of GDP, the Bureau of Economic Analysis, acknowledges this seasonality problem, but GDP does get corrected down the line when items like inventory and international trade statistics are more accurately calculated. This is a known problem. But even if the BEA got it all exactly right for the past quarter***, the hit to the energy and manufacturing sectors likely ground Q1 2016 GDP to a halt.***

It is a lot easier to count jobs than GDP. ***The current run of monthly job gains is the longest on record – an average of about 200,000 jobs have been created per month since September 2010. That is twice the amount required to absorb the growth in the working-age population***, thus driving down the unemployment rate. Obviously job growth in the energy and manufacturing sectors has been bad, but aside from that, the breadth of job growth across industries, pay scales, and regions has been impressive.

An argument against our asserting that job growth is currently a better indicator of growth than GDP is that hiring is not as good as it was during the best of times. Yes, an average of 300,000 jobs per month would be better than 200,000. But given the record number of open job positions, we can speculate that businesses are not able to find qualified workers. Yes, that's a structural problem for the long-term.

In the intermediate-term it has translated to a positive as there has been a surge in workers voluntarily leaving their jobs given their confidence to find new jobs at higher wages (the confidence is a sign of strength in the labor market).

An economy nearing full employment and with stronger wage growth will be a substantial tailwind to consumers. ***Not only will discretionary income rise, but optimism will allow for some of the spending of all that money which has been saved from lower oil prices***.

The downside? With full employment, wage growth, and more consumption comes interest rate rises from the Federal Reserve. The Fed raised rates in December 2015 but has been on hold ever since. With its full employment mandate likely being met this summer, it can hold off as inflation is still well below its target of 2%. But inflation likely won't hold off for too much longer once full employment is reached. ***The longer the Fed holds off on responding to the tighter labor market the greater the risk that it will need to raise rates more quickly next year and perhaps the year after to properly normalize interest rates.***

With the US pushing interest rates up (albeit slowly) and nearly the rest of the world cutting rates, there is a logical argument for a stronger dollar to be had. In fact, the real trade-weighted value of the US dollar has been on the ascent over the last year, putting it at its highest level since 2003. Of course, aside from interest rate differentials, this is being driven by a stronger US economy. However, given that the strengthening of the dollar is likely to continue, it is important to recognize that a strong dollar can hurt some parts of the economy.

There is no need to do a deep dive into an economics textbook here. But, in general, businesses that export find that their products and services become more expensive to foreigners and that hurts sales and profits. But there is a benefit to a stronger dollar – if you are a business that imports products, or if you are a consumer buying foreign goods, then your costs go down and your discretionary income goes up (which, not to get into circular logic, potentially benefits all domestic companies as more dollars can be spent).

So you can see why there is some debate over what is better or worse for the economy – a stronger dollar or a weaker dollar. So let's, for the moment, drop the debate and look into historical correlation of stock price movement relative to currency movement***. In broad terms, a stronger US dollar tends to hurt manufacturing, textiles, and oil-related industries. And, generally, correlation favors construction and real estate sectors.***

In regards to a rising dollar, some potential bad news for profits – when the US dollar rises, oil prices typically fall. The problem is that ***the stock market needs stable and nominally higher oil prices to obtain better corporate margins and, thus, profits. And this, we suspect, is why stock prices have been so closely correlated to oil prices this year.***

The crash in oil prices over the last couple of years has driven earnings of some Energy companies to the negative. Obviously the earnings season has just started, but according to FactSet, the Energy sector "is expected to be the largest contributor to the revenue decline for the S&P 500 as a whole. If the Energy sector is excluded, the estimated revenue growth rate for the S&P 500 would jump to 1.7% from -1.2%." Given that the capitalization of Energy company stocks only comprises about seven percent of the index, this is a significant drop in Energy earnings. According to FactSet , that earnings drop will be

massive as "the Energy sector has recorded the largest decrease in expectations for year-over-year earnings since the start of the quarter, to -103.8%".

For the first time in history, margins for the overall S&P 500 (including Energy) are significantly lower than the S&P 500 ex-Energy. Outside of Energy, margins are still relatively close to their 2015 peak. An increase in oil prices would help close that gap in margins and bring profits back to levels that would help justify stock market valuations.

Bottom Line: Although investors have already pretty much forgotten about the Q1 correction in stock prices, that doesn't mean it was a good quarter for the economy or for corporate profits. Looking at jobs data, we still don't see a recession (which is why we told investors that we weren't worried enough about a 15% drop in stock prices to try to get out and then get back in– it happens; we don't like it, but it happens. And it happens quickly.) The economy will reach full employment this year, wage growth will improve, and the Fed will at some point have to deal with inflation reaching its target of two percent. And this puts the Fed in a position where they will possibly have to raise rates more quickly than the stock market may be comfortable with. But that is likely a 2017 story. Before then we hope for a stabilization in oil prices, even at these much higher levels than just months previously, as not only does less volatility bring predictability (and stocks prices enjoy predictability) but because a restoration in the profits of Energy companies will lend to justifying stock market valuations.

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The Knowledge and Experience to Build Your Wealth

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