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# Have Things Changed Since Jackson Hole?

***The general consensus is that the Federal Reserve's chair, Janet Yellen, has not materially changed her "dovish" stance (i.e. inclination to keep interest rates unchanged/low) per her remarks last week at the annual "Economic Symposium" in Jackson Hole, Wyoming. Leading up to the Jackson Hole meeting, the S&P 500 Index had increased over 8% in price while smaller cap stock indices were up slightly, if not down, on a year-to-day basis. Have the dynamics of the U.S. stock market changed since the Jackson Hole gathering? We believe that there is growing evidence that they might have indeed changed, if not at the meeting itself, then in the weeks leading up to the event.***

## Subtle, but Powerful

Chairperson Yellen's remarks at Jackson Hole were largely consistent with her past statements and they indicated no dramatic departure from her well known viewpoint that the Fed should remain highly accommodative by keeping interest rates well below historical levels for a significant period of time (at least until sometime next summer). Yet, she did acknowledge that the labor market had improved on a relative basis more quickly than anticipated and that the difference between where the labor market is presently, versus where the Fed would like it to be, might be more "structural" than "cyclical".

***Said another way…***

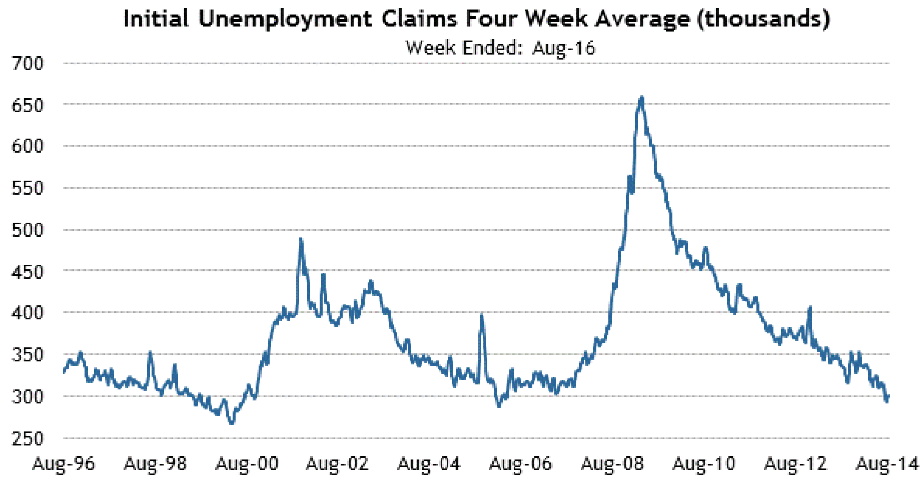
*"If you thought you were travelling at 25 mph towards a brick wall one mile away, you probably would not be too concerned. On the other hand, if you find out that you are traveling 50 mph and that the brick wall is only one hundred yards away, you may be a bit more* ***attentive****."*

The "slack", or the underutilized portion of the available workforce, is represented by the distance to the wall in the above example. Due to factors such as demographics and/or education/training, the perceived "reserve" of workers may not be as large as some, including the Fed, might think. If that reserve of available workers is not as large as one thinks, and you are reducing that surplus quicker than you thought (driving faster towards the wall), the Fed (and ultimately "we") have a potential problem, the threat of labor cost-driven inflation. To the extent the Fed can have an impact on the dynamics of the economy, they can only hope to influence the "cyclical" factors like the availability and cost of borrowing. Structural factors like demographics and/or a

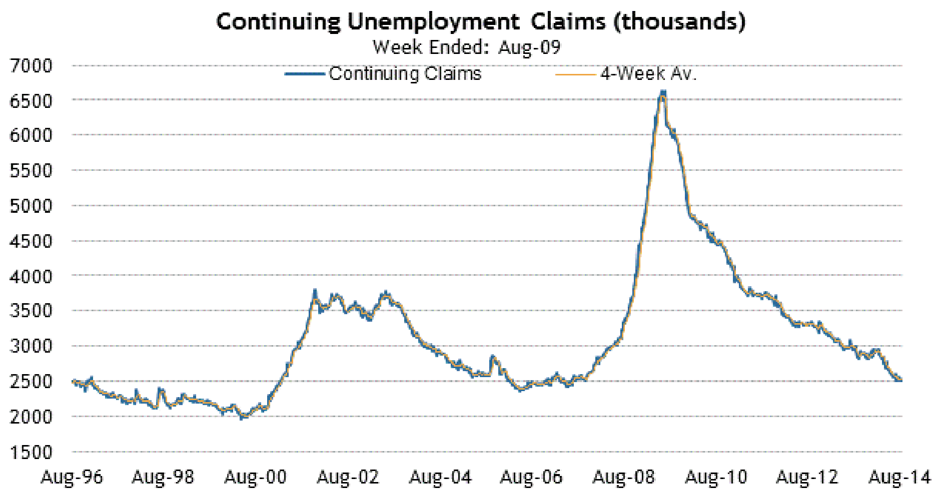
shortage of skilled workers cannot be effectively addressed by monetary policy, but if monetary policy grows the economy too quickly, the pool of available workers may be too small, the costs associated with keeping/attracting workers can rise quickly, and businesses will pass those costs along via higher prices for products and services. If those rates of price increases are too fast, the Fed will have little choice but withdraw liquidity and/or raise interest rates in an effort to slow the economy and risk a recession.

Some indicators of labor market tightening:

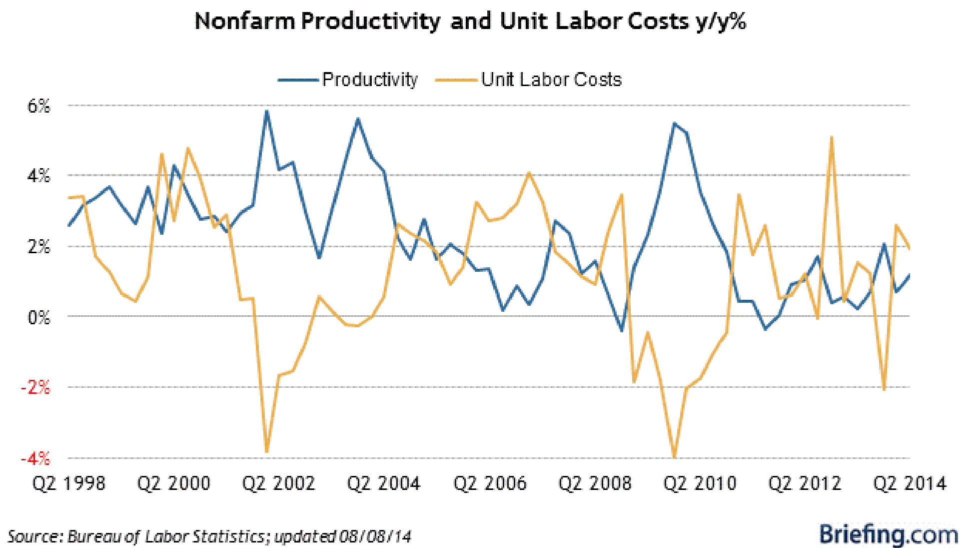
**Initial unemployment claims are back to/below pre-recession levels:**




**Continuing Unemployment claims are back to pre-recession levels:**



**Productivity has been trending down, and Unit Labor Costs trending up, since 2010:**




Keep in mind that a labor shortage is only one factor that may contribute to increased labor costs and inflationary pressures. Benefit costs, healthcare in particular, and both national and local efforts to increase minimum wages can exacerbate labor cost-driven inflation.

## Relative Equity Index Performance and Interest Rates

Over the past year the S&P 500 Index (a large company stock index) has outperformed the Russell 2000 Small Cap Index by more than 7% in price terms.

**1-Year Chart Comparing the Price Change of the Russell 2000 Small Cap Index ETF (IWM) vs. the S&P 500 Index:**

Large, and especially "mega", cap stocks/indices tend to be more interest rate sensitive than mid and small cap stocks. As a result, when interest rates decline, large cap stocks tend to outperform small cap stocks. Given this

relationship, it is not surprising that interest rates have generally declined over the past year while large cap stocks/indices have outperformed.

**How did the U.S. stock market respond to Yellen's speech at Jackson Hole?**

During the trading day that Yellen spoke, the following ETFs performed in perfect alignment given their average, underlying, relative company size (assuming that her remarks were at the margin less "dovish" and that the probability of higher interest rates had increased):

| | |
|---|---|
| Dow Jones Industrial Average ETF: | -0.18% |
| S&P 500 Index ETF: | -0.16% |
| Mid Cap Index ETF: | -0.09% |
| Small Cap Index ETF: | +0.01% |
| Micro Cap Index ETF: | +0.15% |

We have had a couple more days of trading since then, and while not quite as "perfect", small/micro-cap indices are up between 1-1.5%, while large/mega-cap indices are up less than 0.5%.

**What data has been released since Jackson Hole?**

The economic data that has been released over the past week has not only been good, but it has surprised many economic forecasters:

Durable Goods Orders rose 22.6% in July and June's figure was revised upward from 1.7% to 2.7%

Q2 GDP was revised up from 4.0% to 4.2%

Within the Q2 GDP calculation, Real Final Sales were revised up from 2.3% to 2.8%

Consumer Confidence rose to 92.4, the strongest reading since 2007

Pending Home Sales for July rose 3.3%; forecasts were expecting a figure closer to +0.5%

The Chicago Purchasing Managers Index increased to 64.3 in August from 52.6 in July with most forecasters expecting a figure below 55.

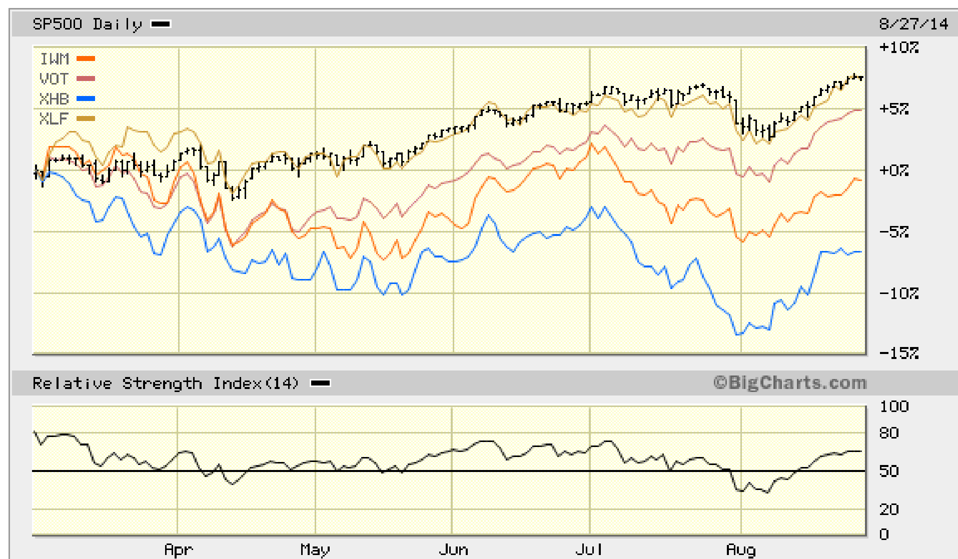
The University of Michigan Consumer Sentiment Index for August increased to 82.5 (final) from the preliminary reading of 79.2.

**Strategy Implications**

Even though it was widely known that weather and inventory adjustments were largely responsible for the U.S.'s Q1 GDP decline of 2.1%, fears of recession and hopes of a slowing/reversal of the Fed's "quantitative easing" tapering program materialized nonetheless. We saw most of the investments that had performed best in 2013 begin a sharp decline in early March (as it became apparent that Q1 GDP was going to be quite weak, thereby giving the Fed increased justification to keep interest rates low), while the S&P 500 Index not only maintained its value, but actually rose more than 5% (i.e. the positive benefit of lower interest rates outweighed the negative impact of slower economic activity):

**1-Year chart showing the 12 months leading up to March 1, 2014; Small Cap (IWM), Mid Cap Growth (MDY), Homebuilder (XHB) and Financial Sector (XLF) ETFs on average outperformed the S&P 500 Index**

**The below chart covers the period from March through late August of this year (almost a 6 month period); Small Cap (IWM), Mid Cap Growth (MDY), Homebuilder (XHB) and Financial Sector (XLF) ETFs on average underperformed the S&P 500 Index for the first 5 months, but they have shown initial signs of strength during past month as the economic outlook has improved:**




The emotional and capital market effects of the U.S.'s Q1 GDP decline appear to have not only subsided, but are now being forcefully reversed as indicated by both changes in the relative strength of more economically sensitive parts of the U.S. equity market vs. more defensive segments (like mega/large-cap defensive stocks) and recent economic data. Increasing tightness in the labor market, as well as rising labor costs, are going to make it difficult for the Fed to justify a slowing of their current move towards reducing/eliminating their quantitative easing program. In addition, increases in short-term interest rates may not wait till next summer (as Yellen has indicated) either because the fixed income market moves

ahead of the Fed, or because the Fed is compelled to move up their time schedule. Even if short-term rates do not begin moving up till next summer, we are already within the 6-12 month window in which the stock market typically begins to respond to anticipated future events.

The recent outperformance of the S&P 500 vs. almost every other U.S. equity index is not a trend that is likely to continue if the improvement in the economic data for the U.S. persists and the Federal Reserve responds accordingly.

To be fair, the economic activity that led to the recent string of stronger economic reports occurred well before the economists met at Jackson Hole. In addition, the re-emergence of price strength in smaller, more economically-sensitive stocks/indices also occurred before that well publicized event. So perhaps the change began before the Jackson Hole meeting. There was nothing in the pre-released, written transcript of Yellen's remarks that clearly indicated a material change in her stance, but during the actual speech her slight changes in wording, her tone and/or her body language was apparently interpreted as a further indication that the probability of higher interest rates had increased and that the change in the U.S. stock market investors' focus (that being the rotation back into smaller and more economically sensitive company stocks/indices) was warranted. The economic data that has been released since that speech has only further supported that interpretation.

**"Look to the Future, be Optimistic…but Hedge."**

*(We want to keep these commentaries brief and focused so as to provide a good "information-to-text-length ratio", but if you have specific questions/topics you want me to address, please let us know.)*

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