November 9, 2015

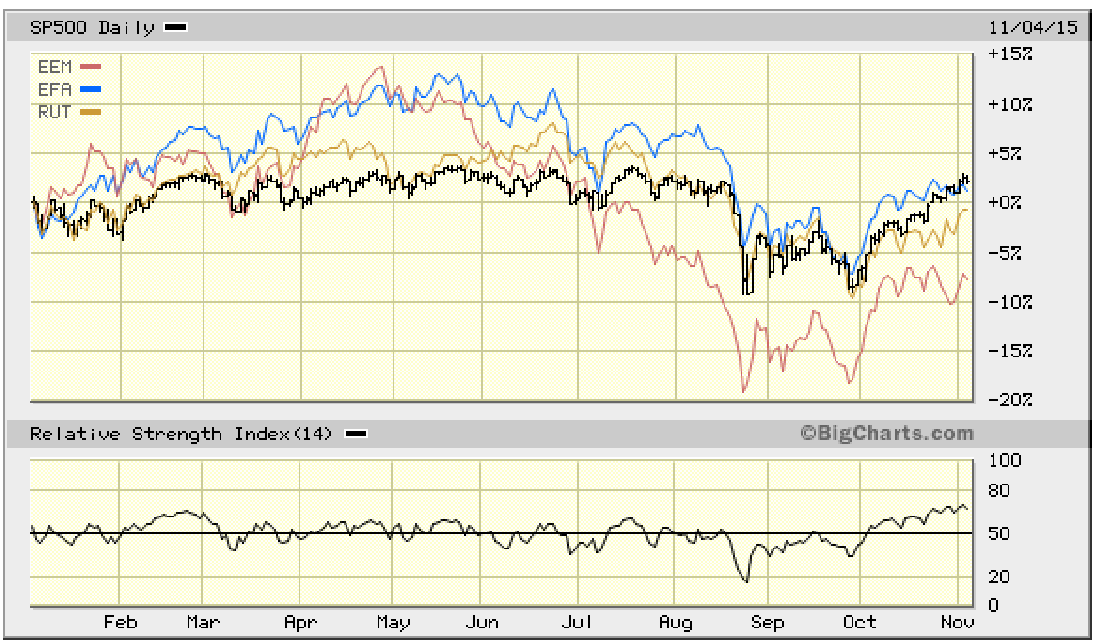
Global Stock Market Leadership: No Change or Just a Delay?

Market & Strategy Update

Last August, during the initial weakness of the recent stock market correction, we pointed out that stock market leadership changes tend to occur as we emerge from the bottom of a stock market correction. Early indications are that there was not a significant change from what we've seen over the past 4-5 years because the S&P 500, which has dominated most other equity indices over that time period, is within 1% of its pre-correction high while most other equity indices are still well off their highs. Is this a sign that nothing has changed, or is it a distortion caused by the Fed's reluctance to raise interest rates in September and their concurrent, "dovish" statements that all but ruled out a 2015 rate hike later in the year? The answer to this question has significantly changed in just the past week.

"Cyclical Run" followed by "Summer/Fall Slump"

As can be seen in the below 2015 YTD chart, during the first four months of 2015 we had a classic, global, cyclical stock rally with the emerging markets (ticker: EEM) leading, the non-U.S. developed equity markets (EAFE Index; ticker: EFA) following closely behind and small company U.S. stocks (Russell 2000; ticker: RUT) outperforming the S&P 500 Composite Index. Yet, as we approached the summer months, the economic data became mixed/weak and concerns about China's future economic growth potential became paramount in investor's minds. As a result, almost all equity indices suffered at least a 10% decline from their highs in April to the lows we saw in the August through September timeframe:



The U.S. Federal Reserve responded by not only postponing an initial Fed Funds rate hike, but also by highlighting some of their concerns about global growth, especially in China, and the general vulnerability of capital markets in general to a premature "launch date" for their efforts to increase interest rates. While initially the global equity markets responded by pressuring stock prices lower in the days that followed, investors eventually pulled out their 2012-2014 "play books" and began buying large cap, U.S. stocks once again, resulting in the S&P 500 taking the lead ahead of the other major equity indices.

A Silent "WHOOPS!" from the Federal Reserve's Federal Open Market Committee (FOMC)

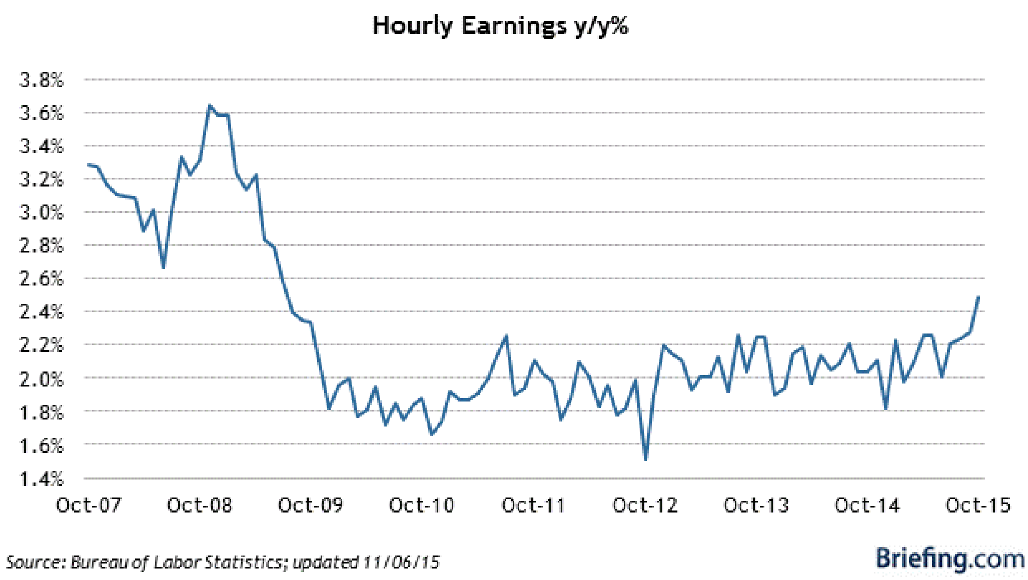
An excerpt from the FOMC's September press release:

"*Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term*."

The silent "WHOOPS" from the FOMC came in the form of the above sentence being deleted from last week's October meeting press release and with that the potential for a December rate hike was "back in play", or as Chairperson Yellen described it today: "*December would be a live possibility*".

How about a little "egg" for that red face?

Some of the FOMC members were fairly open about their mild embarrassment that they had essentially lost their nerve and did not show greater resolve in pursuing a course of action that in hindsight appears to have been more prudent. For those members who needed a little more evidence that they overreacted in September, they got a large "egg" placed squarely on their forehead in the form of a very strong labor report on Friday. Not only did the 271,000 in new jobs come in about 50% above consensus, the unemployment rate dropped to 5% and hourly earnings rose 0.4% which was about double expectations. The rise in hourly earnings is probably the most concerning aspect of the report because labor costs are a primary driver of inflation in economies such as ours which is overwhelmingly services oriented. The Fed's inflation target is 2%, but they have indicated that they would be willing to tolerate a slightly higher rate of inflation (around 2.5%) during this recovery to provide a wider cushion against deflation. As you can see in the below chart, the year-on-year rise in hourly earnings is right around 2.5% and it is accelerating:



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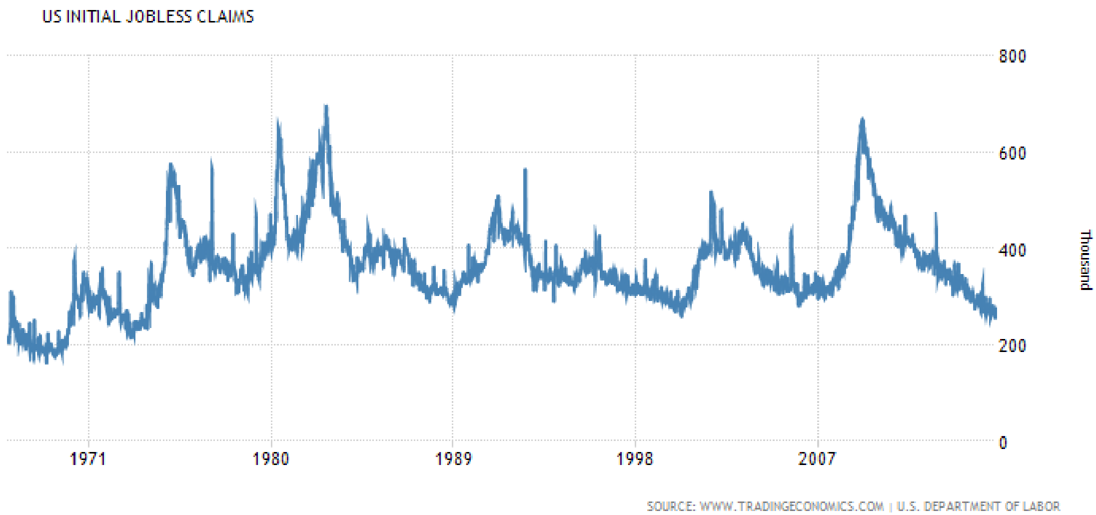
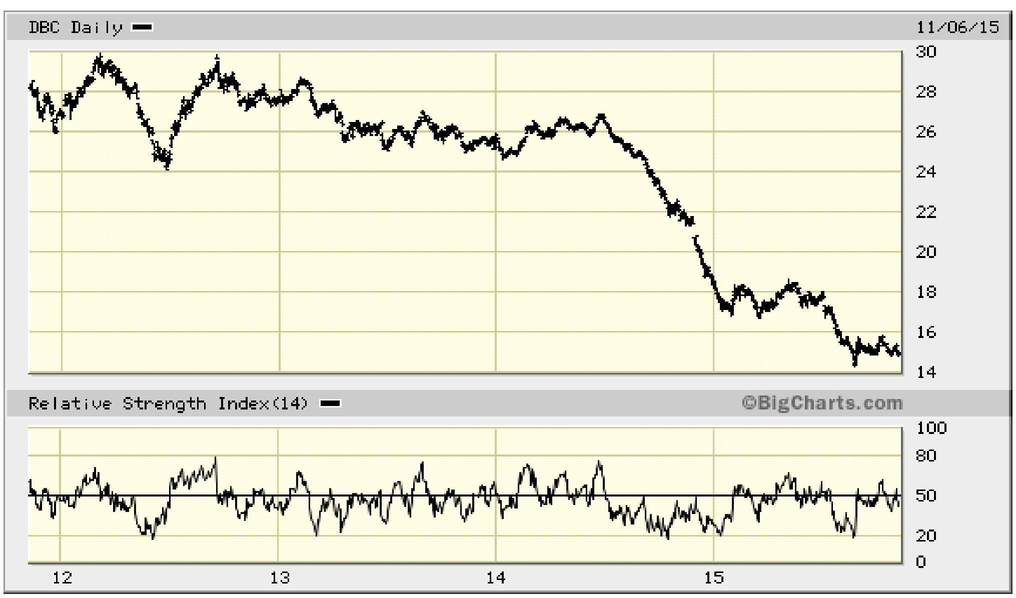
This strong labor data followed Thursday's Initial Jobless Claims report that showed we are continuing to fall to levels in unemployment claims we have not seen since the late 1960's/early 1970's:



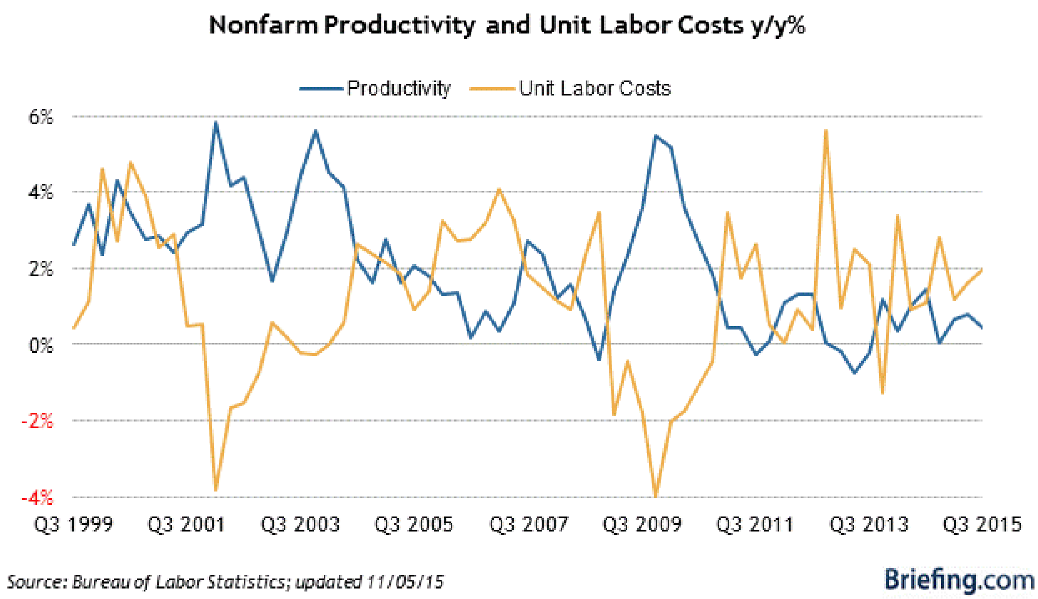
Rapid Job Creation + Stabilizing Commodity Prices + Anemic Productivity Growth + a Zero Interest Rate Policy = A Bad Case of Insomnia for FOMC Members

Below is a 4-year chart of the DB Commodity Index ETF (ticker: DBC). As you can see, there has been about a 50% drop in commodity prices over that period. There was an attempt at stabilization during the first few months of this year, but then another swift decline occurred during the summer. However, commodity prices have once again begun to show signs of stabilization since the August lows:



Rising labor costs can somewhat be prevented from translating into high levels of broader inflation if commodity prices continue to fall, or at least remain steady, but more importantly, if productivity is rising at a similar or higher rate than wage costs. Unfortunately, productivity has been growing at less than a 2% rate since

2010 (closer to 0-1% in recent quarters). The net result of this is that Unit Labor Costs are poised to rise above 2% if current trends continue:



Last week's labor report significantly increased the probability that the Fed will raise interest rates in December. In response, the U.S. Dollar rose over 1% against the Euro, oil price fell over 1% and gold fell almost 1.5%. A stronger dollar, and weaker commodity prices, can help contain inflation, but if hourly earnings continue to grow and begin to approach/exceed a 3% growth rate, and productivity growth is insufficient to keep unit labor costs from rising to a level of 3% or higher, lower oil prices will not be effective in preventing the rise of inflation fears at the Fed. This could cause the Fed to increase interest rates much more quickly than they have indicated, or would prefer to do given a choice. As history has shown, they may not have a choice.

This Is Not Your Father's Labor Market

A large number of the jobs recently created were in the healthcare industry. It is important to remember the two sides of the demographic trend driving the employment growth in this sector. As more people become elderly and unable to work, the remaining labor force shrinks just as more people are needed to support the growing elderly population. This dynamic will significantly increase the importance of both immigration policy (will we have sufficient people of working age to assist the elderly?) and job training (whether immigrant or natural-born citizen, what training will be needed to re-purpose the available workforce to provide elder care services?). Also, unlike manufacturing, capital investment cannot boost productivity to the same degree within a highly labor intensive industry like healthcare. Yes, the promise of robotics, telemedicine, remote sensing and other technologies can ease the potential labor shortages of the staff needed to assist those who require, or desire, assistance to varying degrees, but the industry remains a "people business" and automation/off-shoring can only take you so far.

Strategy Implications

If the global economy (excluding China) continues to strengthen, and China can find an equilibrium rate of growth such that investors feel confident that the deceleration in their GDP growth has approached a bottom, a stronger U.S. dollar will not likely keep commodity prices from eventually rising as current production continues to be curtailed. The combined effect of an increase in global economic growth, and stable to rising commodity prices, will most likely result in a cyclical bull market in which emerging markets, commodities/commodity producers, materials and industrial products begin to perform as well, if not better, than the current leaders of biotech, healthcare, consumer discretionary and technology…***but we are not there yet***. We need to see the Fed actually begin to raise interest rates, employment continue to improve and global economic growth concerns continue to subside. So to answer the question that serves as the title to this commentary: "Global Stock Market Leadership: No Change or Just a Delay?" We are in the "just a delay" camp. Small company stocks, non U.S. equities, the emerging markets and commodities (in that order) should take the lead from the S&P 500 (and keep it this time) as we get greater clarity around the Fed's new path and as we can better assess how much the U.S. Dollar strengthens in response to that new path. Between now and the end of the first quarter of next year we should have a much clearer view of how this change in market dynamics will play out.

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

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