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Something to Think About

COMMON CENTS

Thanks to the August Employment Situation report, today was almost a damned if you do and damned if you don't day. If the economy created "too many" jobs in August, many feared a Fed rate hike, sooner rather than later, would be a near certainty. If the economy created "too few" jobs, well, the economy was/is weaker than expected, and that isn't too good either. Pick your poison

With that said, I am not sure I have ever seen such a confounding reaction to a lukewarm economic release in my career. Seriously, this morning's jobs report was about as benign as a plain bagel with nothing on it, not even toasted. Okay, I have to admit I don't care if I ever eat another bagel in my life. So, you might have to pick your own poison on that.

Still, although I knew stock futures were in negative territory when I got to the office, I breathed a sigh of relief when I saw the headline number, 173K net new jobs. It was comfortably less than what analysts had predicted, but still a decent number. Further, a quick review of the entire release found nothing that should sway the opinion of anyone sitting on the Federal Open Market Committee.

In so many ways, it was just what the doctor ordered before trading desks across the country boarded up at lunch for the long weekend.

Now, the kneejerk rebuttal to this would be: "what are you talking about Norris? The Unemployment Rate fell from 5.3% to 5.1%, which is at or near the Fed's target to start raising rates." Fair enough, however, there are three ways to reduce the Unemployment Rate: 1) create a large number of jobs, or; 2) cut the number of folks actively looking for employment, or; 3) some combination thereof.

Guess what happened in August, and if you choose #1 or #2 I am going to ask you to guess again.

During August, according to the Household Survey (which is where they get the Unemployment Rate), the number of people (of working age) not participating in the labor force increased 261K. As a result, the Labor Force Participation Rate (LFPR) fell from 62.62% to 62.55%. Guess what? That 0.07% differential is/was enough to drop the Unemployment Rate 0.11% all by its lonesome. Throw in 196K new jobs in the Household Survey, and, voila, the Unemployment Rate falls to 5.11% from 5.26% in July….however, when rounded to the nearest tenth, we go from 5.3% to 5.1%, which looks a better.

In other words, new jobs were responsible for only 0.04% of the decline in the Unemployment Rate. The rest of it was due to folks simply opting out.

What's more, in August 2014, the LFPR was 62.85%. If it had been the same in August 2015, assuming the same number of employed, the Unemployment Rate would be 5.57%. This is important for a reason: prior to 2015, the last time the LFPR was as low as 62.6% was in, get this, October 1977. That was a pretty long time ago. How long? Let's just say Reggie Jackson got his nickname Mr. October during the World Series that year, and Jimmy Carter moved into the White House that January.

Further, the Employment to Population Ratio (EPR), a good indicator of Median Household Income and thereby consumer strength, was only 59.4%. While this has bounced from the 20-year low in

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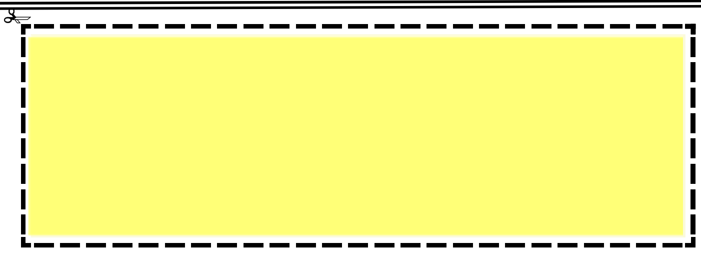

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November 2010 (at 58.2%), it is still well below that time period's average of 61.7%, let alone the monthly high in April 2000 at 64.74%.

To put those numbers into perspective, IF the EPR was 61.7%, there would be an additional 5.89 million employed Americans today. IF it was the same as that all-time high, we would be looking at 13.535 million new jobs. As such, it is hard to say the US labor market is anything other than improving. If we can't say much more than that, how can we suggest an economy based largely on consumer expenditures is doing anything but improving?

If we are improving, but not quite back to the average, and the annualized GDP growth rate over the last 20 years (through 2Q) is 2.4%, well, is that what the Fed is trying to throttle? A 2.0-2.5% growth rate? I don't know, and I apologize for this overly simplistic argument. Let's just say, the report was fine...okay...decent, but not much more, or less, than that. There certainly wasn't anything in it which would suggest a 263 point day in the Dow Industrials, in either direction.

Today should have been, and would have been in a simpler time, a +/- 75 point day, and the die would have been cast by 11:00 am.

With this all said, let me give you what I submitted to the Montgomery Advertiser this week. I rather like it, and thinks it sums up the current situation pretty well….in roughly 600 words. Here it goes:

> **The markets have been all over the place, mostly bad, and everyone is still worried about the Fed raising interest rates. Why would it when everything looks as lousy as it does right now?**
>
> That is a great question. Do you have another one that would be easier to answer?
>
> For all its collective intelligence, sometimes it seems the Federal Reserve operates in something of a vacuum. I mean these are smart people, brilliant even, but there are times I wonder if they focus more on equations and forecasts, mental gymnastics if you will, than on the reality of the situation.
>
> Imagine you see a man walking down the railroad tracks, his head in a book, with a train rapidly bearing down on him. You yell to him to get off, and he replies: "Why in the world should I? The 12:19 isn't due around here for another 30 minutes." The best part? He might be absolutely right, and I mean to the minute.
>
> Sometimes the Fed seems like the man on the tracks, but is it?
>
> Right now, the most oft-given reason I have heard in favor of raising interest rates is the Fed wants to get back to a sense of normalcy. Fair enough. The data has been reasonably sufficient to perhaps warrant taking the foot of the gas just a little. Further, if a couple of quarter point raises in the overnight lending target pushes the economy off the cliff, it was going over at some point anyhow.
>
> However, when you look at things like money supply velocity and growth, the official inflation gauges, median household income, the labor force participation rate, and the relative strength of the dollar,

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you could make a pretty compelling argument the Fed doesn't have to be in a hurry to do anything. Basically, the US economy doesn't appear to be in danger of either overheating or falling apart, just more of the same.

Still, there is something out there that is very troubling, namely debt.

According to the Federal Reserve, total Credit Market Debt Outstanding, table D.3 of the Z.1 release for those keeping score at home, was $33.755 trillion at the end of 2008. At the end of the 1st Quarter of 2015, it was $41.714 trillion. That is difference of $7.959 trillion, or 23.6% growth, which is a lot of money over 6.25 years, but what have we gotten in return?

According to the Bureau of Economic Analysis, the US economy grew about $2.931 trillion, or 19.9%, from 2008 through the end of the 1st Quarter in 2015, unadjusted for inflation and subject to revision. So, we have borrowed about $8 trillion, at least in the official credit markets, to generate roughly $3 trillion. There is a word for that: weak.

The reason? I would submit it is because debt is cheap, and our collective demand for debt will continue to be high as long as it is. Remember, debt isn't a bad thing if you can borrow money and turn it into even more, in fact it is a good thing. However, when you are borrowing $8 to generate $3, well, at some point you won't be able to do that much longer, and wouldn't want to in any event.

The Fed knows, or should, how inefficient our borrowing has been, but how does it wean us off debt when that would likely cause even more problems in the short-term.

Therein lies the reason for its mental gymnastics.

To me, this is a much bigger concern than whatever the Unemployment Rate might do any given month. Over the last decade, our rate of borrowing has simply outpaced the rate of economic growth. There is no denying that, even if you want to counter with the asset side of our collective balance has grown faster than the liabilities. This too is true. However, I would come back with the various Quantitative Easing programs really skewed the data. The Fed basically gave the US Treasury about $3.7 trillion, which the latter didn't have to borrow from either domestic or international investors. This undoubtedly had an impact on the multiple expansion we saw in equities starting at the end of 3Q 2011, as it enabled the US Treasury to borrow at rates it probably wouldn't have been able to otherwise. Therefore, if we can assume interest rates would be higher but for the explosion in the Fed's balance sheet, you can reasonably assume equity valuations wouldn't have gotten as high as they did at the end of 2014.

Then all we are doing is arguing what the fair P/E multiple would have been but for the Fed's $3.7 trillion largesse, and how much foreigners would have had to finance the US Treasury and at what rates. Frankly, we could argue until the cows came home, and it wouldn't probably wouldn't solve anything because the infusion of that cash impacted just about every line item of our collective balance sheet. Let's not forget the various similar programs in Japan and Europe, and how a decent amount of that money probably found its way onto our balance sheet in some form or fashion.

Oh….I suppose I could go on, but I won't, as there are any number of roads, slippery slopes, and rabbit holes from which to choose. However, I will tell you this: our current predicament started years ago, when we started expecting too much out of the Federal Reserve, and gave it too much power to do things like print money out of thin air, allow the US Treasury to borrow at undoubtedly below market rates, and keep interest rates between banks at essentially 0% for as long as it wants.

That last phrase is important: for as long as it wants. Well, just how long is that? Does a 173K net new payroll number do the trick? If so, what if I were to tell you another part of the report said there was an increase of 158K part time jobs. Would that change the Fed's mind? I suppose only the Shadow knows, and he ain't telling until September 17.

...and that is how one of the most mediocre Employment Situation reports can cause a completely outsized conniption fit in the equity markets: mental gymnastics, and I gave you plenty of that today.