MV CAPITAL MANAGEMENT

Weekly Market Flash

Apocalypse Where? The Case for (Guarded) Optimism

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The most contentious U.S. presidential election in modern history is approaching its dramatic conclusion, and the media discourse is saturated with breathless prognostications of doom and gloom. Even the stock market has gotten in on the act, with the S&P 500 retreating eight days in a row and flirting with a 5 percent pullback from the record high of 2190 set way back in the middle of August. Trumpkins and Clintonistas alike (not to mention "Pox on Both Houses" malcontents) see a Dark Ages v2.0 on tap if their candidate fails to snag 270 Electoral College votes next Tuesday. Strange times, these.

The Devil's in the Data

And then there are the data. Actual numbers, lovingly compiled by earnest toilers at the Bureau of Labor Statistics and the Bureau of Economic Analysis and various other Bureaux in our fair land, reflecting how the economy is doing through the prism of job creation, price trends, consumer habits and much else. These numbers have painted a fairly consistent picture for the past couple years: moderate but below-trend growth, a weak recovery in wages and prices, stable spending patterns and improving consumer confidence. One important trend that appears to be solidifying is that of real wage growth.

Below today's headline jobs number of 161,000 new payroll gains (which itself is notable in extending the post-Second World War record number of consecutive monthly jobs gains) is the 2.8 percent year-on-year growth in average hourly wages. This is not an outlier; wage growth in recent months has consistently outpaced inflation, whether measured by headline or core (ex food & energy) CPI or by the Fed's preferred Personal Consumption Expenditures (currently 1.7 percent).

Real wage growth indicates that, after all those months of falling unemployment and new payroll gains, the labor market is tightening along the lines of historical norms. Those gains should help push consumer prices further towards the 2 percent target rate as a higher chunk of household earnings finds its way into spending on staple and discretionary goods and services. That, in turn, should be good news for GDP, about 70 percent of which derives from consumer spending. This is the virtuous circle that has driven past periods of economic growth.

One Cheer for Productivity

Sustained economic growth, as we never tire of pointing out, derives from growth in the overall population, or from an increase in the percentage of the population at work, or from improved productivity per average hour worked. That third option is critical, and economists have been puzzled by the chronic recent failure of the economy to achieve meaningful gains in productivity. In fact, productivity as measured by the BLS had decreased for three consecutive quarters leading up to the release this past Thursday (given the importance of this metric to overall growth, why is there no celebrated Productivity Thursday, along the lines of the popular Jobs Friday nerdfest?).

In any case, Q3 productivity surprised to the upside, growing 3.1 percent against expectations of 1.7 percent. That's good! But of course it is only one quarter, so too early to break out the Veuve Cliquot. The other good thing about productivity, though, is that productivity gains help businesses leverage their operational expenses, including labor expenses. Improving productivity, all else being equal, should enable businesses to accommodate wage increases (see above) while maintaining or even improving profit margins.

Connecting the Dots from Macro to Earnings

Maintaining those profit margins will be extremely important for businesses as they try to work themselves out of the recent funk in corporate earnings. Average earnings had fallen for five consecutive quarters heading into the current (3Q16) earnings season. With about 85 percent of S&P 500 companies reporting, it appears the negative streak will come to an end: expectations now are for 2.6 percent EPS growth, as opposed to the minus 2.6 percent expected at the beginning of the quarter. That's all well and good, but investors are keen to see a return to the double-digit earnings growth environment of years past. Productivity gains will need to continue to offset the effects of a tighter labor market.

Meanwhile, the headwind effect of the U.S. dollar should be expected to continue if, as likely, the Fed goes ahead with a resumption of its rate hike program come December. And while the virtuous cycle of stronger demand may take root here at home, there are still too many pockets of weakness and uncertainty in other geographic markets where large U.S. companies manufacture and sell. In short: an improved U.S. economy won't be of much help to domestic share prices unless the dots between macro and earnings can be connected.

The Human Effect

Our optimism will thus remain guarded until we see more evidence of an improved economy having a measurable impact on business performance. Which brings us back to the topic that opened this commentary – the upcoming election. Is there any substance to those abundant prophesies of the imminent apocalypse? Or, in other words, how much actual damage could politicians create to choke off any nascent improvement in our little economic garden?

We must, of course, be cognizant of the profound dissatisfaction registered by many voices – not just here at home but around the world – against political structures and other perceived elite institutions. The dissatisfaction certainly influences the policy discourse and shapes how political leaders present themselves and their policy intentions. But we remain of the view that, regardless of what configuration of Democrats and Republicans win their races next Tuesday, the more extreme elements of their platforms will have a very hard time finding their way into actual law.

History has shown that ill-conceived human intervention can have a real, long-term negative impact on a society's standard of living. History also shows, though, that revolutions don't happen far more often than they do happen. We may live in strange times, but we do not see them as strange to the extent of Petrograd 1917 or Paris 1789. Until we have reason to think otherwise, we remain guardedly optimistic.

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