

Global speculations

Looking Up

Global Asset Allocation Strategy

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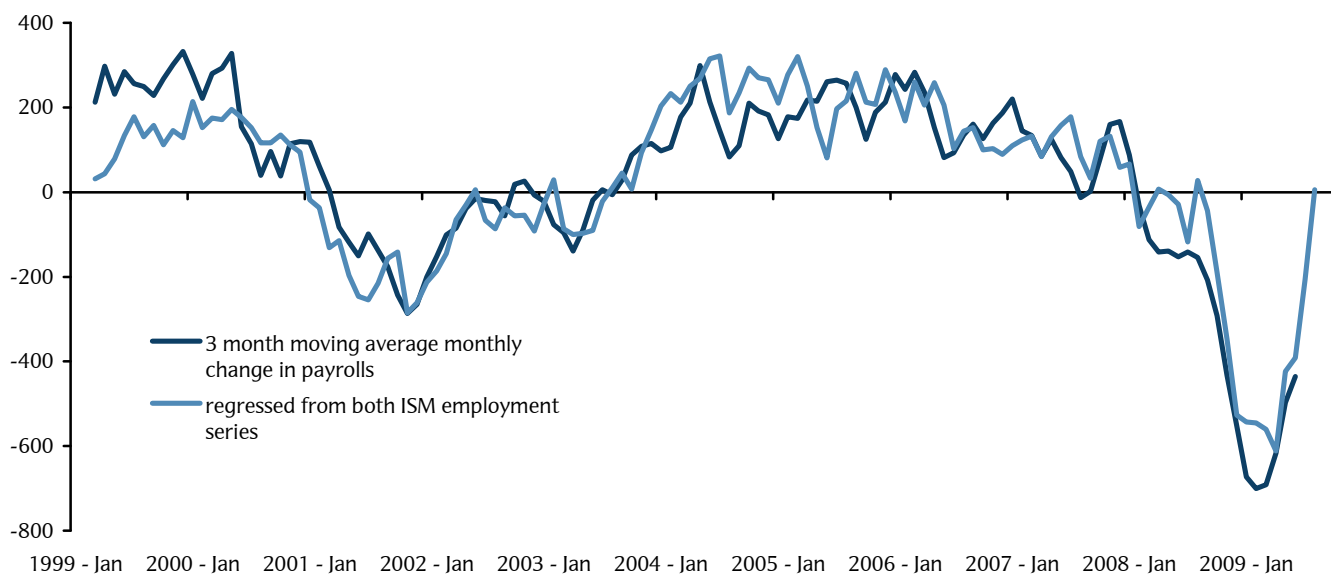
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Existing data confirms that a sharp improvement in the US labour market is due over the next three months. The June payrolls report, contrary to market perception, was entirely consistent with the recovery story. The return to positive growth, whether in output, profits or employment, is in the process of occurring right now, with the “turning point” covering the June-September period. Historic data is therefore much less meaningful than usual. The current consolidation in the markets is a good opportunity for investors to raise exposure to cyclical assets.

The June employment report appears to have raised concerns regarding the fate of the US economic recovery. In a market that remains generally sceptical of an imminent return to positive US growth, the latest payrolls data are being interpreted as a signal that the risk of a more prolonged recession has risen. In fact, such fears are groundless. The June change in payrolls was consistent with the trend we can infer from other measures of activity, such as the twin ISM reports. The employment components of both the ISM series lead the three-month moving average of the monthly change in payrolls by one to two months, with correlations of over 80%. The joint ISM employment reading in May was consistent with the trend in payrolls standing at a 400k contraction in June, which was more or less what we saw in the actual number. Since May, the ISM employment series have registered a further improvement, which would be consistent with the trend in payrolls improving to three-month moving average of a 200k monthly loss of jobs in July. This expectation is in line with other evidence from the durable goods and ISM production series, both of which inform us that US industrial production only returned to a positive rate of growth in June. Since employment follows output with a lag, the major improvement in labour market should only be seen later in the summer. To be sure, the 200k decline in payrolls forecast by the ISM employment series is still a weak number, even if it is a distinct improvement from the trends seen in the spring. However, we can be very confident that the rate of contraction will continue to slow sharply in August. This confidence is predicated on the very strong leading correlation of over 90% between the twin ISM new orders series and the employment series. New orders lead employment by one to two months, the regression displaying an R-squared of 0.87. Although the ISM manufacturing new orders series slipped slightly in June, the non-manufacturing series rose by over four points to 48.6. Taken together, these two order series therefore point to a rise in the employment components of the surveys next month. In turn, the rise in the employment series implies a fairly dramatic improvement in the payrolls trend. Figure 1 illustrates this point. In this exhibit, we show the actual and modelled three-month moving average of the monthly change in payrolls. The modelled series is derived from a regression on the sum of prior month's two ISM employment series. The last data point, which is for August, has been generated using the ISM employment numbers forecast by the current new orders readings. As you should be able to see, the improvement in the labour market is dramatic, suggesting an end to the job losses.

Figure 1: Actual and modelled three-month moving average of monthly change in payrolls



Source: Haver

As we have noted in previous publications, the massive decline in inventories over the past nine months strongly biases the outlook towards rising orders and output over the remainder of the year. As a consequence, the improving trend in the jobs market is likely to be sustained, with an increase in payrolls employment due towards the end of the third quarter. A sharp improvement in the payrolls trend should be visible in the data for July and August, with the weekly initial claims data providing a contemporaneous indicator of developments in the labour market. Markets are currently reacting to the June employment report. In so doing, they are offering an opportunity for investors to position for the sharp change in labour trends that will be visible over the remainder of the summer. Our advice is to increase exposure to cyclical assets during the current corrective phase. Conversely, it is reasonable to suppose that government bond yields will rise somewhat as clear confirmation of an improvement in the labour market becomes visible.

We note that a similar timing applies to the trend in company earnings. At the moment, the focus of scrutiny is on Q2 earnings. Such a focus is backward looking and not particularly relevant to the impending trend in profits. Profits are due to rise with output, as the past savage decline in employment feeds into a sharp rise in operating leverage once volumes begin to increase. Throughout most of Q2, US output was declining, with the turnaround in industrial production most likely only occurring in June. As a result, Q2 earnings will be a singularly poor guide to the rise in profits that is due in Q3 and Q4. Overall, we would summarise our argument with the observation that the return to positive US growth – whether we consider employment, output or profits – is an event that is in the process of occurring right now, in the June-September timeframe. And since we are in the midst of the cyclical turning point, historic data is of very little relevance to the actual state of the economy. We reiterate our advice to use the current pause in the cyclical asset rally to add to long exposures.

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