



August Commentary

Jobs, Interest Rates, and Oldies but Goodies

As much of the country utters a collective sigh of disappointment that the summertime season has passed and realizes that retail stores have already begun stocking shelves for the holiday season ahead, in this month's newsletter I address some of the most common topics, questions and concerns we hear from clients and prospective clients – when will interest rates rise, why can't I find employees, and how much higher can the equity market go? All great points indeed, but for me, the real question is when did retailers start selling Halloween costumes, Thanksgiving items, and Christmas décor and gifts all at the same time?

Are you an optimist or a pessimist? Do you see the glass as half-full or half-empty? Are unexpected setbacks problems or opportunities? Do you see silver linings or dark clouds? Do you just keep your head down, not ask questions, and hope no one asks you any? The reason I ask is because how you view the world may skew the way you interpret the following data and reports. In early September, the Bureau of Labor Statistics (BLS) released the headline jobs number for August, and it was shockingly bad. By that I mean it was way off analysts' estimates. The "street" had estimated the U.S. economy would create 733,000 net new payroll jobs during August. However, the report showed that total non-farm payroll employment rose by only 235,000. That, my friends, is a big miss! A called third strike with the bases loaded! A missed one-foot putt! A fumble on your opponent's goal line!

But wait a minute, the Department of Labor (DOL), which encompasses the BLS, recently announced there were over 10 million job openings waiting to be filled. This was easily an all-time high of unfilled jobs! They said there were 1.1 million available jobs in retail trade, another 1.5 million in healthcare and social assistance, and a whopping 1.4 million openings in accommodation and food services. Combined, that accounts for more than 4.1 million potential paychecks just waiting to be cashed and spent. However, during the month of August, job growth in these three economic sectors showed a net loss of 68,000 jobs. A net loss! How does this happen? Inquiring minds want to know.

We Are Hiring. Apply Now. Please.

The experts will have a myriad of different reasons why this report was so disappointing, likely much of it focused on COVID, and how its spread has slowed down "re-openings" and the like across the country. Perhaps this is the case; however, I see Now Hiring signs and posters on pretty much every grocery store, retail store, and restaurant I enter around town. I have even seen employers take out billboard space promising attractive hourly rates and signing bonuses for unskilled and semi-skilled labor. At one of my favorite casual seafood haunts, I saw a rather tempting ad offering signing bonuses of \$3,000 for waitstaff. My wife was quick to refocus my misguided enthusiasm and bluntly informed me that I am neither patient enough nor friendly enough to serve people food and drinks. Touché, my dear, touché. So dire is the shortage for workers around here that one pizza joint owner was interviewed on TV and said he would literally

hire anyone who could fill out an application. So, again, why does this happen? What is going on here?

Maybe this is where we should step back, re-evaluate and make sure we are seeing all sides of this jobs story. In fact, the BLS conducts two surveys, one that focuses on corporate HR departments and another that tracks U.S. households. Over time, these two reports tend to converge, but most recently they diverge in a big way. According to the report that focuses on U.S. households, the economy created over 500,000 jobs last month, and the official unemployment rate fell from 5.4% to 5.2%. This is the lowest unemployment number since the start of the pandemic and that job growth number is more than double the headline survey total of 235,000. One other thing, this report shows a sharp decrease in the official unemployment rate among workers who have “less than a high school diploma” and “high school graduates, no college.” Confusing, isn’t it? How can one survey suggest job losses in lower skilled occupations and the other show substantial growth? It appears the BLS is giving us a somewhat confusing look at the labor markets: is the glass half-full or half-empty?

I believe a huge part of the issue are the weird and unusual times in which we live. Specifically, I mean the unprecedented times in which the government, in all its many forms and guises, has seemingly confused the heck out of things with its pandemic relief programs. Do not get me wrong, I am not suggesting that most of these programs have not been warranted or necessary. I am just wary that many of our leaders and politicians have allowed or wanted too much government overreach and dependency. Also, are businesses paying employees under the table so they will not lose unemployment benefits — technically employing people, but not creating actual payroll jobs? Are lower skilled workers jumping from job to job to be both part of the labor markets and still receive unemployment benefits? Listen, I do not know exactly what game is being played, but looking at the data, I cannot help but assume that one is being played.

The idealist in me believes we will have a better understanding of the underlying strength of the U.S. labor markets after September and some of

these questions will be put to rest. Hopefully, the Delta variant will have peaked, schools across the country will have opened, and those extra federal unemployment benefits will have expired. At that point, we may find the labor markets are not as weak as the current data suggests, but they probably will not be as strong as many would hope. Either way, it pretty much guarantees the Federal Reserve will continue to fill up its “punch bowl” through the end of the year and delays, at least for a couple of months, any tapering the Fed was considering. That should bode very well for the market and investment portfolios.

Interest Rates — Going Up?

“We expect rates to move upwards over the next couple years” may be one of the most often repeated comments heard every day in the financial media. While this sentiment is nearly universal, it is an easy bet for three main reasons: inflation data has continued to run hot, the economy continues to show signs of recovery, and rates must go up eventually, right? This rising rate expectation is about as cliché as the traditional cookie cutter expectation of 6-8% returns for any given year in the equity markets. These stereotypical expectations are cookie cutter for a couple of reasons: they reflect probable outcomes, and it is easy to rely on historical norms. Let us take a moment to understand the ingredients used to make the cookie dough.

Quality is the first word that comes to mind when thinking about a higher interest rate environment, especially in the equity space. A key ingredient to any equity valuation is what is called the discount rate. The discount rate is the cost of capital for a company, and when interest rates rise, the discount rate rises as well. Since the price of any stock is ideally the present value of the future cash flows discounted back to the present, this is where quality comes into play. If a dollar is worth more now than in the future, we place a higher value on those companies that produce quality cash flow now. We want a quality business model with quality cash flow and high-quality demand. Hey, did I mention quality?

What about bonds or fixed income assets? Well, higher interest rates means lower bond prices, and if rates do rise, most of the fixed income universe will suffer. If quality was the primary characteristic

for equities, the focus for fixed income is similar, but slightly different. The key ingredient for bonds in a rising rate environment is duration. Let me explain. Duration is defined as interest rate sensitivity, and when rates are rising, we want all our assets to be getting us the highest possible rates. The longer your duration, the longer you must wait for the payment of interest coupons and principal. Practically speaking, when it comes to fixed income, we want shorter duration assets if rates are going to rise — this means we get our money back quicker, so we can invest those dollars in new, higher paying bonds. Short duration bonds are better than long ones when rates rise, but they are not always ideal. The problem with shorter duration fixed income assets is the less risk (short-term bonds usually mean lower interest) you take, the less immediate reward you receive. So, where does fixed income fit in a portfolio right now? Well, currently there are not many places to hide, as common sense tells us we do not want to own depreciating assets in a rising rate environment. However, properly managing the duration of your fixed income assets along with minimal overall exposure to satisfy risk-based allocation parameters is paramount when rates begin to rise.

As far as equities are concerned, they are often the best place for our investment dollars in a rising rate environment. Historically, the S&P has averaged nearly 6% per year when interest rates are rising, and while this is not much to write home about, it has been more than most other asset classes. Returns will undoubtedly be harder to come by when rates rise; however, this does not necessarily mean negative returns. It means asset managers will have to work a little harder for their returns and that is a challenge for which our team will be prepared.

Name That Tune

If you are of a certain age or like listening to the Oldies channel, you might recall a song by Herman's Hermits called "I'm Henry the Eighth, I Am." If so, you know it is a very odd song (a horrible song, in my opinion). You may also recall that the first line of lyrics to the start of the second verse is quite simply, "second verse same as the first." Silly for sure, but appropriate because the Hermits simply repeat the first verse over and over until the very end of the song. Amazingly, in 1965 this unconventional, uncouth, uncool song

amazingly dethroned "(I Can't Get No) Satisfaction" by the Rolling Stones from atop the Billboard chart. I bring up this nearly useless bit of trivia because August's pertinent market news seems quite like July's: 1) the potential tapering of the Fed's monthly asset purchases, 2) the employment story and 3) the transitory inflation debate. Essentially, "second verse same as the first."

However, there was something quite different about August and it centered on the question or some variant thereof that I heard from clients or prospective clients, "how much higher can the stock market go? It seems very overvalued." Fair enough. Here has been my answer: "There is nothing in our crystal ball that suggests the stock market will be able to generate the same results over the next 12 months that we have seen during the last 12 months. On the flip side, there is nothing to suggest stock prices are going to fall unexpectedly or for very long either." How is that for being non-committal and tactfully vague?

Although my answer might seem intentionally ambiguous, I mean it wholeheartedly. We would be shocked to report the same YTD and 12-month results this time next year. At the same time, there is no data suggesting an impending sharp market correction — especially one of the 2008 variety. While it is impossible to accurately predict so-called "black swan events," the U.S. stock market, as defined by the price/earnings ratio (P/E), is expensive by historical standards. Currently, the trailing P/E for the S&P 500 Index is roughly 27x earnings, and by comparison, that same ratio going back to the mid-1950s is closer to 17x. As another point of reference, prior to the stock market bubble bursting back in the late 1990s, the P/E was 29x stated earnings. So, in absolute terms, we are much closer to the valuations of the 2000 bubble than we are the median P/E for the last 65+ years. Does that mean it is only a matter of time before things go bust? Probably not.

The problem with comparing today's valuations with the past is that market conditions are not the same. Here is a simple analogy comparing the average height of an American male throughout the past century that may drive this point home. Today the average height of an American male is 5'9"; however, 100 years ago, it was closer to 5'6". Due to a variety of factors (better nutrition,

superior healthcare, etc.) American males are taller now than they were in the past. The subject, an American male, is the same but the conditions and time period are the variables. Now, let us compare today's investment markets to just two decades ago. Currently, the yield (interest rate) on cash/money markets, as defined by the 3-month Treasury Bill, is less than 0.05%. The yield on the 10-Year U.S. Treasury Note, a common proxy for the bond market, is around 1.25-1.35%. And finally, the dividend yield on the S&P 500 Index is 1.31%. Interestingly, the stock market today is yielding way more than cash and about the same as the bond market. By comparison, on Dec. 31, 1999, these same representative yields were 5.33%, 6.44%, and 1.11%, respectively. In other words, immediately prior to the tech bubble crash in March 2000, investors had other options to generate reasonable rates of return. So, where does an investor turn to generate returns today? The best option for most, if keeping things liquid and reasonably safe, is the stock market, despite the historically high valuations.

As you can see, much about today's market is very different. For this reason, we remain convinced

that stocks continue to be the most reasonably valued of all asset classes. If it helps, think of it this way: Assume you are not a vegetarian, and must choose either ground sirloin or chicken to cook for your family when both poultry and red meat are expensive by historical standards. How much ground sirloin will you buy if it costs \$10/lb. when chicken is just \$5/lb.? Probably not a whole lot, right? Now, how much ground sirloin will you buy at \$10/lb. if chicken is now selling for \$15/lb.? Your answer is undoubtedly different, even though the price of sirloin is still an elevated \$10/lb. Make sense?

Understandably, people get worried when the stock market appears to get overheated. It is only natural. After all, as I wrote about last month, corrections, bear markets and financial system crises are not a lot of fun, are they? No, they are not. Believe me, when things start to look ugly in both absolute and relative terms, we will let you know.

Until next month, "second verse same as the first."

by David Lackmann
Florida Director of Investment Management



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