Don't Ignore the Anecdotes

JOHN MAULDIN | May 7, 2014

Whenever I'm in New York I make a point of calling a number of my economist and investor friends and arranging a "dinner with interesting people." Thankfully, Rich Yamarone is almost always at the table, because his insights into what's happening in the real economy, beyond Wall Street, are unrivaled.

Rich is Chief Economist at Bloomberg and the creator of Bloomberg's *Orange Book*, a compilation of key insights from CEOs, taken from quarterly earnings calls. He is also part of the team of 7 top economists who write the daily must-read *Bloomberg Economics Brief*. (Tom Keene of *Bloomberg Surveillance* is a contributor, too.) If you are a trader, broker, or portfolio manager or are just interested in keeping up with all things economic, this is a good way to do it. You can learn more here.

For today's *Outside the Box*, Rich has written a piece that summarizes his chief concerns about the domestic economy in 2014. Those concerns focus around the fact that growth in both real disposable personal incomes (adjusted for inflation and taxes) and consumer spending have barely advanced in the wake of the Great Recession.

In compensation – and it's an unhealthy form of compensation – government transfer payments as a percentage of disposable income have grown from 9% in 1970 to nearly 20% today.

To make matters worse, the Affordable Care Act (Obamacare) is having a real impact not just on hiring and firing but also on hours worked per employee; and Rich gives us some helpful anecdotes and data on this situation.

I am really looking forward to having Rich – who many of his friends have taken to calling "Lord Vader" – debate David Zervos, Chief Economist at Jefferies, who is more the Obi Wan Kenobe type – sweetness and light and lover of all things to do with quantitative easing.

I find myself this afternoon in Geneva, where tomorrow I will make several presentations and do a lot of interviews. This is a beautiful city but ghastly expensive for someone using dollars.

It seems I caused the recent weakness in the dollar and strength in the Japanese yen by actually buying ten-year put options on the yen. I would expect these things to come back, of course, but perhaps I should alert traders when I decide to put on the rest of the trade. The market so likes to make me look foolish, at least in the short term. Some friends here in Geneva have decided to take me out to eat at a Japanese restaurant tonight as consolation, which is fine, as I do love sushi and things that go with it.

And let me address one failure last week when I was listing the people who helped me with my house and mortgage process. The entire process was orchestrated by my able young associate Shannon Stanton. The massive paperwork would not have gotten done, nor would the budgets or anything else. And my other assistant, Mary Haddad, keeper of the schedule and coordinator of everything, is also key in making my life run semi-smoothly while on the road. Thanks!

Have a great week.

Your thinking about currency flows and valuations analyst,

John Mauldin, Editor
Outside the Box

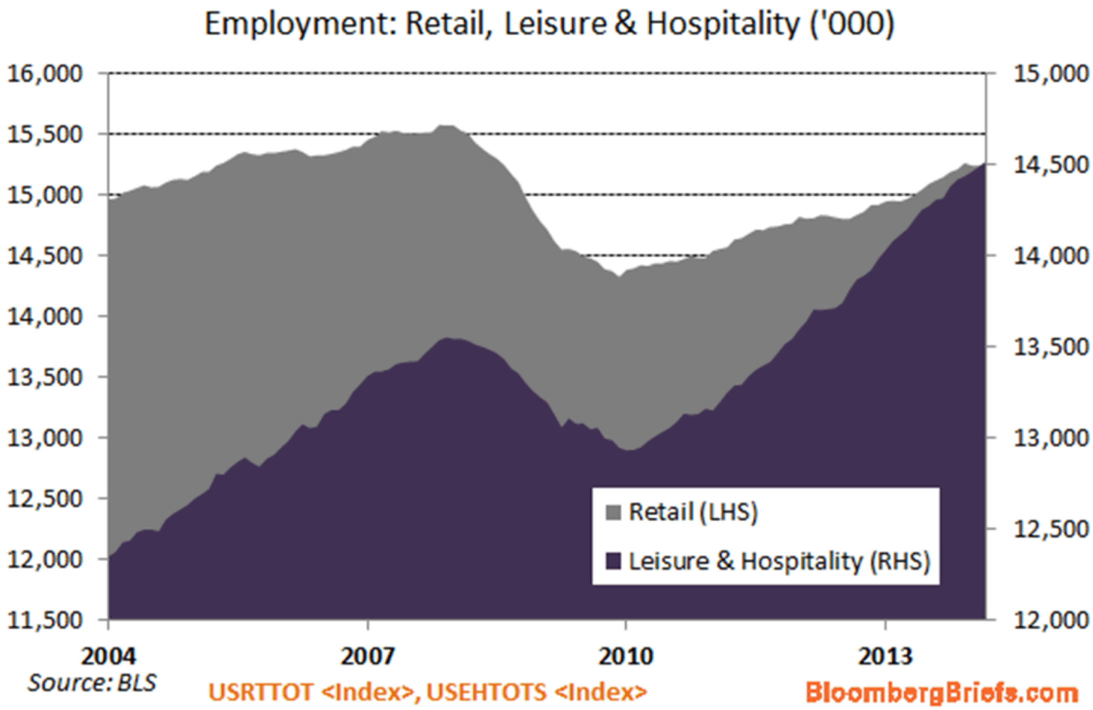
Don’t Ignore the Anecdotes

By Richard Yamarone

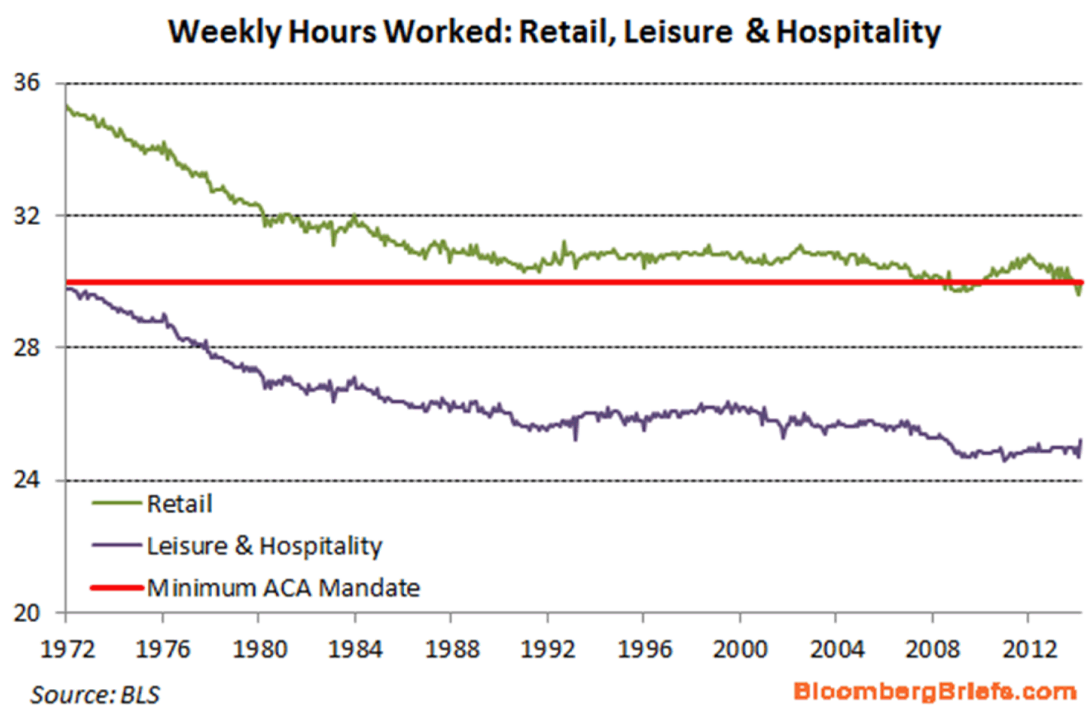
My top three fears for 2014 are: 1) income inequality that erodes the middle class, reducing the income and spending power of the primary engine of the U.S. economy, 2) widespread Chinese economic deceleration and an associated shadow banking crisis, and 3) a possible student loan bubble and widespread defaults amid elevated delinquencies.

After speaking extensively in 2013 and almost every week of this year, I’ve managed to gather a great deal of insight from the ground up – something that economists at big firms generally aren’t permitted to do. Do you think they travel to Conshohocken, PA; Oneonta, NY; San Marcos, TX; or Thibodaux, LA? Probably not. There is a great deal of information to be learned by gathering insights from this grass roots perspective.

Prior to Christmas, sometime around October or November of 2013, while shopping for my wife at the Macy’s flagship on 34th Street in New York, I chatted with the sales associate about how business had been and how she felt about her job. She said: no one buys anything here unless there’s a coupon or a heavy discount. This deflationary mindset remains in place even today. She also noted increased traffic on big discount days.



The comments regarding her employment situation were disturbing. Yes, she has a job – has held it for some 15 years in fact. But her hours worked were getting slashed. What used to be 45 hours, plus occasional overtime, as well as potential "inventory days" (where staffers are asked to stay overnight and estimate stockpiled merchandise) and anticipated holiday hours were reduced to a mere 12 or 15 per week. That's about a 66 percent decline in hours worked.

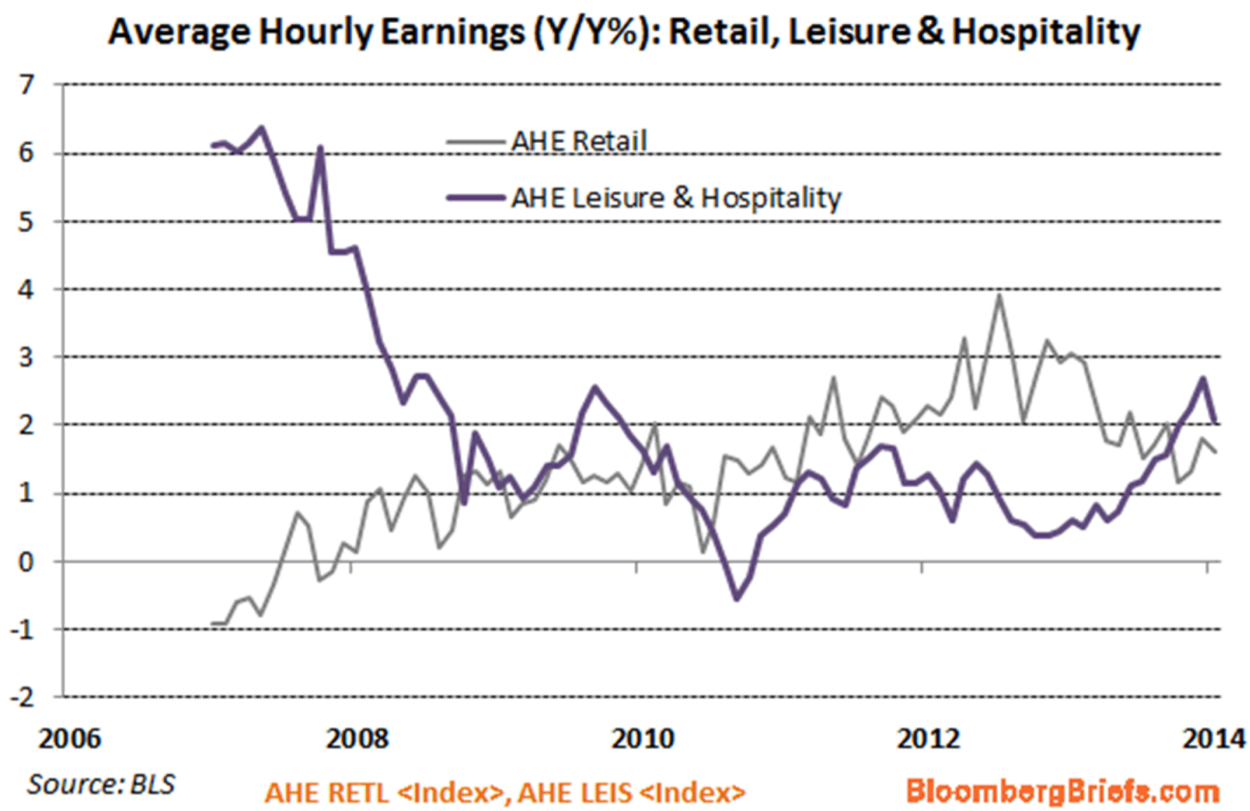


Realizing that she wouldn't be paying any bills with those hours, she was forced to obtain a job at Kohl's. And since that gig was limited to 12-15 hours, she applied for a third position at Applebee's.

Several business people have cited the Affordable Care Act (ACA) as the primary obstacle to hiring and capital spending. Essentially the ACA forces any business with more than 50 employees working more than 30 hours a week to offer some form of health care to its staff. Since reducing staff below 50 is not an option for some restaurant chains, such as Darden Group which employs more than 200,000 people, cutting hours worked is the only viable move. The data support this: hours worked in the retail and leisure and hospitality sectors are below 30 hours a week and hiring has increased in these two industries.

During March, the leisure and hospitality group added 29,000 positions, while retailers increased payrolls by 21,300. Combined, these two industries account for 25 percent of all private workers, so it is a significant percent of the labor market.

The data support this trend of increased low-wage hiring in avoidance of the ACA mandate. When people face certain economic constraints, they don't roll over, they make adjustments, seek opportunities, and do what is necessary to provide for their families.

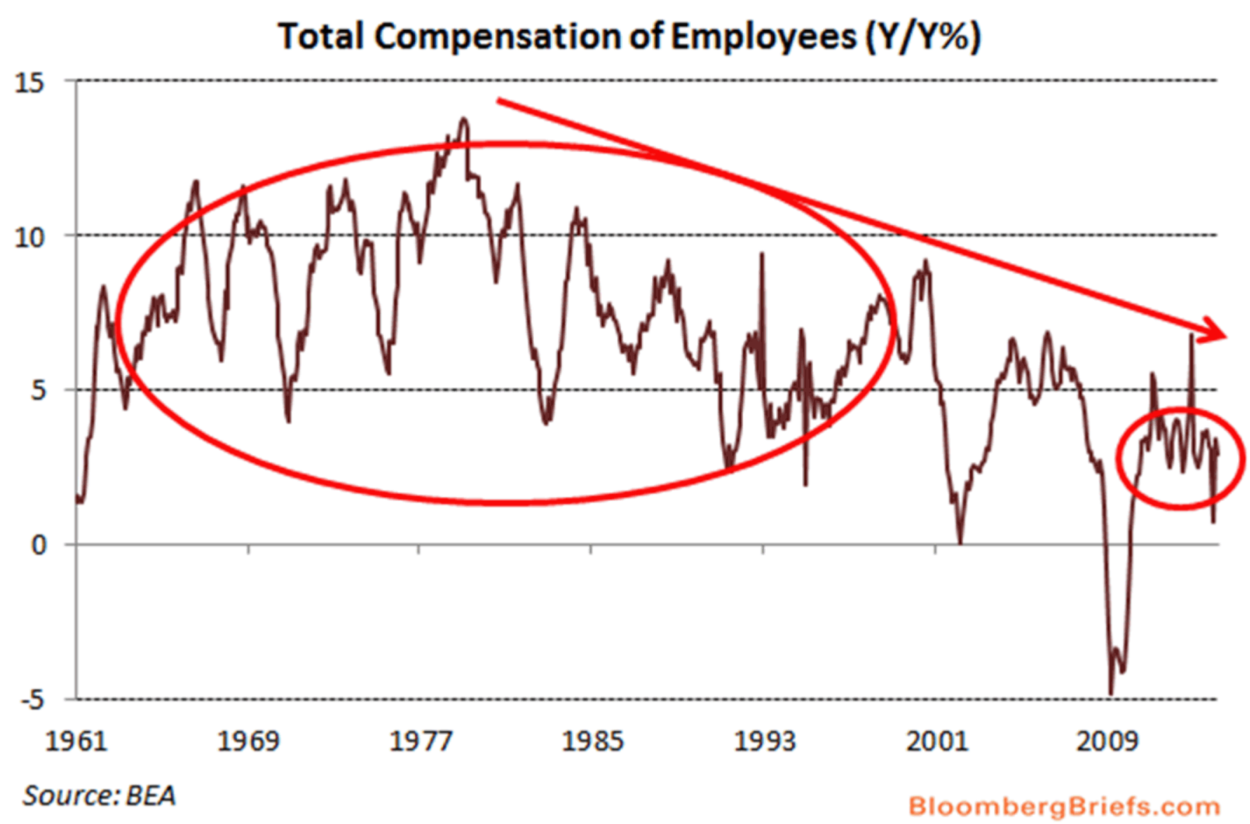


Because the year-over-year growth rate in average hourly earnings for leisure and hospitality is about 1.9 percent – and once adjusted for an inflation rate of 1.5 percent, the real rate is about 0.4 percent – it doesn't seem likely these workers will be willing to increase their expenditures on health care.

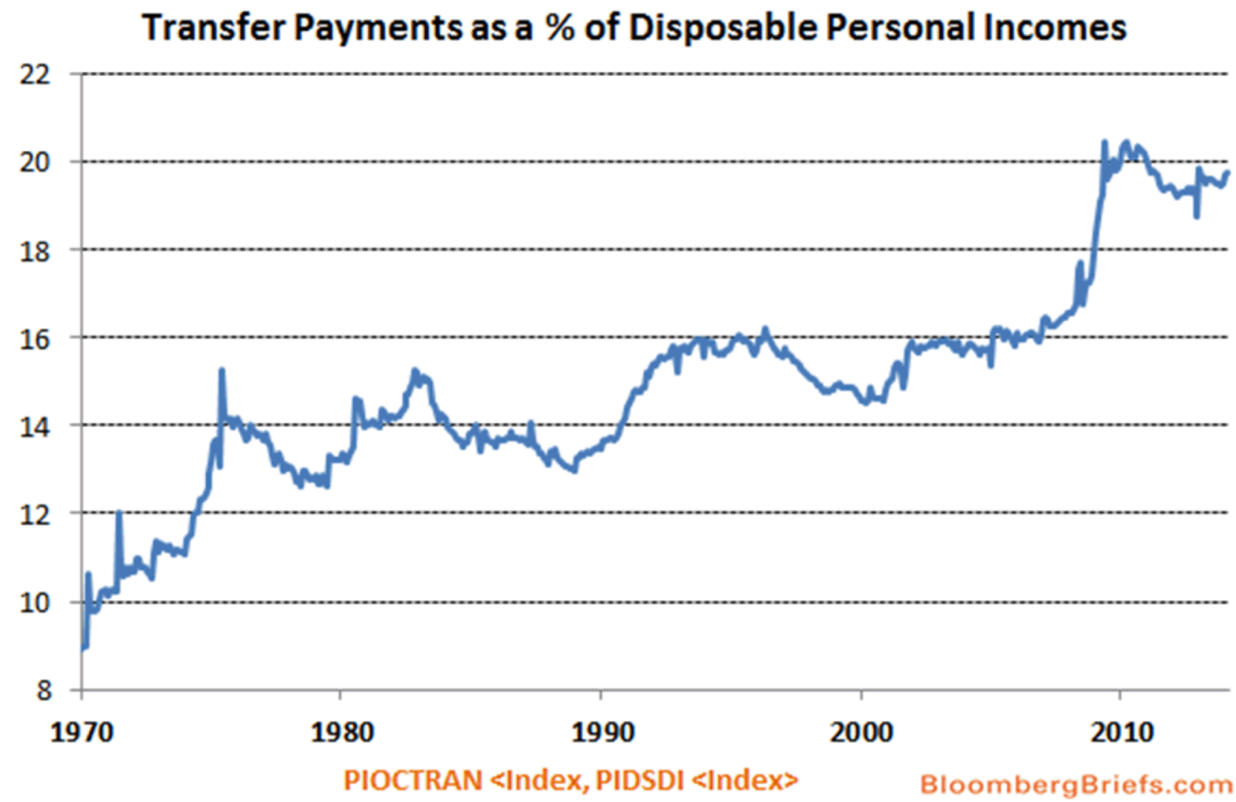
Some companies may be realizing this is a concern for Americans. It may be the reason CVS is beefing up its Minute Clinics presence and jettisoning cigarette sales in an attempt to position itself as a legitimate medical alternative to those that cannot afford health insurance amid stagnant incomes. This insight is out there…you just need to get out and find it.

Affordability has hit all of us, across the entire income spectrum. In order to facilitate spending and subsequently economic growth, there needs to be income. Like gasoline in a car, without the fuel, the engine doesn't run.

During February, real disposable personal incomes – those adjusted for inflation and taxes – advanced 0.3 percent, or 2 percent from year-ago levels. Historically, this is a very soft pace, one that traditionally has market participants unfurling the recession flags. There's a good chance that consumer spending will return to a sullen state of affairs, since incomes are essentially the fuel for future spending – you can't spend what you don't have – and consumers have cut back on their credit card purchases – consumer revolving debt fell 0.3 percent in January.



The level of total compensation of employees is lingering at a year-over-year pace of 2.9 percent. This is essentially unchanged from the range registered since 2010. More importantly, the post 2007-09 depression recovery has had gains in total compensation below levels associated with previous recessions. Total compensation used to run between 5 and 10 percent, with several spikes above 11 and 12 percent. Today we barely break 5 percent.



The incomes report also identified the continuation of elevated levels of government transfers as a percent of disposable personal incomes. The mere fact that the U.S. economy is so dependent upon assistance from Uncle Sam suggests that this recovery will be considerably weaker than historical periods – in other words, more of the same type of recovery.

French economist Frédéric Bastiat wrote about the redistribution of wealth – or " plunder" – in 1850 in *The Law*: "There are only two ways of obtaining the means essential to the preservation, the adornment, and the improvement of life: production and plunder.… What keeps the social order from improving (at least to the extent to which it is capable of improving) is the constant endeavor of its members to live and to prosper at one another's expense."

Since the level and composition of incomes are somewhat suspect, expectations for spending should also be called to question. Real consumption expenditures, which increased 0.2 percent, or 2.1 percent since February 2013, are also at a dangerously low level – since this too is a pace that has seen the economy experience a downturn in the past.

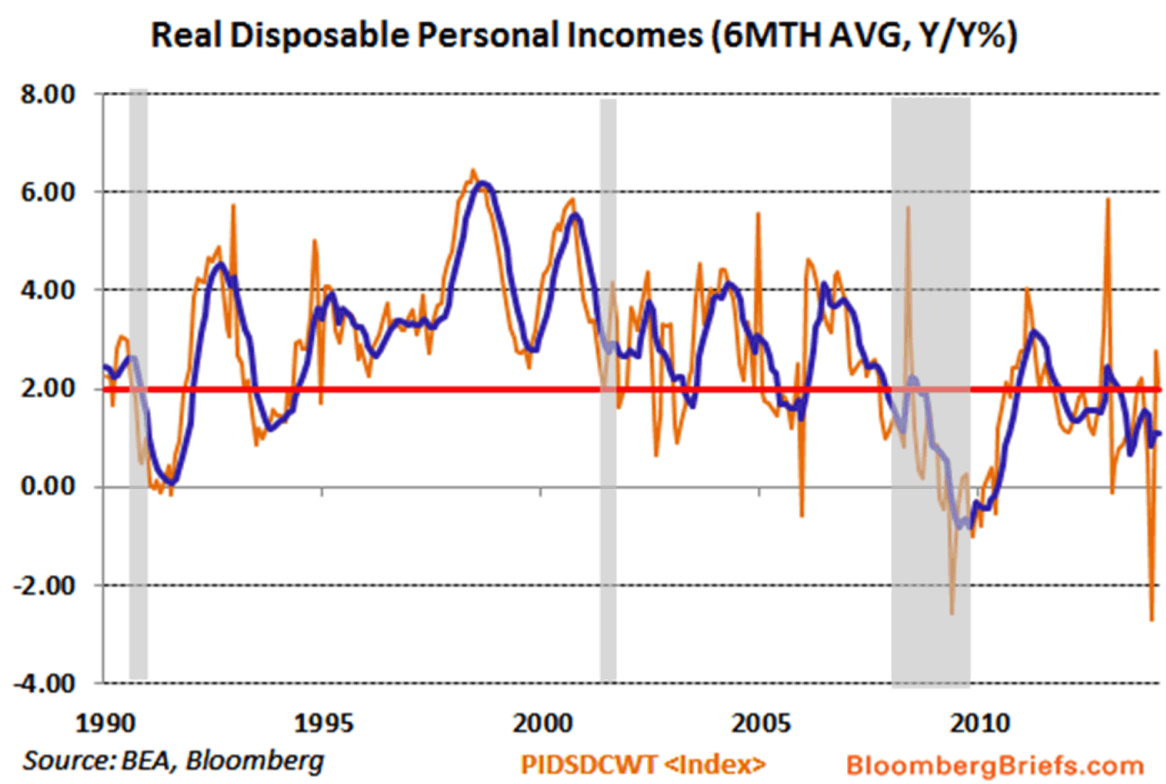
Spending on my "Fab Five" indicators of discretionary spending is not entirely favorable. The ultimate discretionary purchase, dining out, was unchanged in February, and only 0.9 percent higher than 12 months ago. While casino gambling increased 1.5 percent, it was 6.5 percent lower than February 2013. Expenditures on cosmetics and perfumes inched up 0.4 percent, or 0.9 percent year over year, while women's and girls' clothing increased 1.55 percent in the month and 0.9 percent year over year. The strongest of the "Five" was spending on jewelry and watches, which climbed 3.5 percent in the month, and is 7.3 percent above year ago levels. This shouldn't be surprising since they are popular Valentine's Day purchases.

Essentially the economy is running on an empty tank of very low-octane fuel. Compensation growth is weak, and the reliance on government transfers is unlikely to spark any cylinders. Expectations for a solid recovery should remain reduced until there's a definitive improvement in the quantity and quality of personal incomes.

The employment situation improved in March as a total of 192,000 nonfarm payroll jobs were added, the labor force participation rate increased, and there was a decrease in the number of long-term unemployed (27 weeks or more). The less welcome components of the release included an unchanged, stubbornly high 6.7 percent unemployment rate, a slower pace of average hourly earnings, and a record level of temporary staffing workers as a percent of total employment.

The 192,000 job increase had a better mix than in recent months, which is encouraging. It isn't always the total number of positions added, but the composition of those jobs. About 47 percent of those jobs created last month were in the low-wage category – accommodation and food services (33,100), temporary staffing agencies (28,500), retail (21,300), and social assistance (7,600). This is an improvement from the better-than 55 percent registered in recent months.

One frequently cited "improvement" by many economists in their post-release commentaries was the 0.2 hourly increase in the average workweek in March for all employees on private nonfarm payrolls to 34.5 hours. On a year-over-year basis however, this remains unchanged. In fact, looking at the industry breakdown of those 12-month changes, the largest percent gains by industry was mining and logging, a staggering 4.6 percent higher from March 2013 and information, which experienced a 1.6 percent gain. The disheartening issue is that mining and information are the two smallest major categories with 898,000 and 2.6 million workers respectively. The two weakest performers, education/health (minus 1.6 percent) and retail (minus 0.6 percent) were among the two largest employers with 21.3 million and 15.2 million respectively.



Average hourly earnings slipped to $24.30 an hour in the last month, and increased a lowly 2.1 percent during the last year. Once adjusted for inflation of about 1.1 percent, the level of real average hourly earnings was about 1 percent.

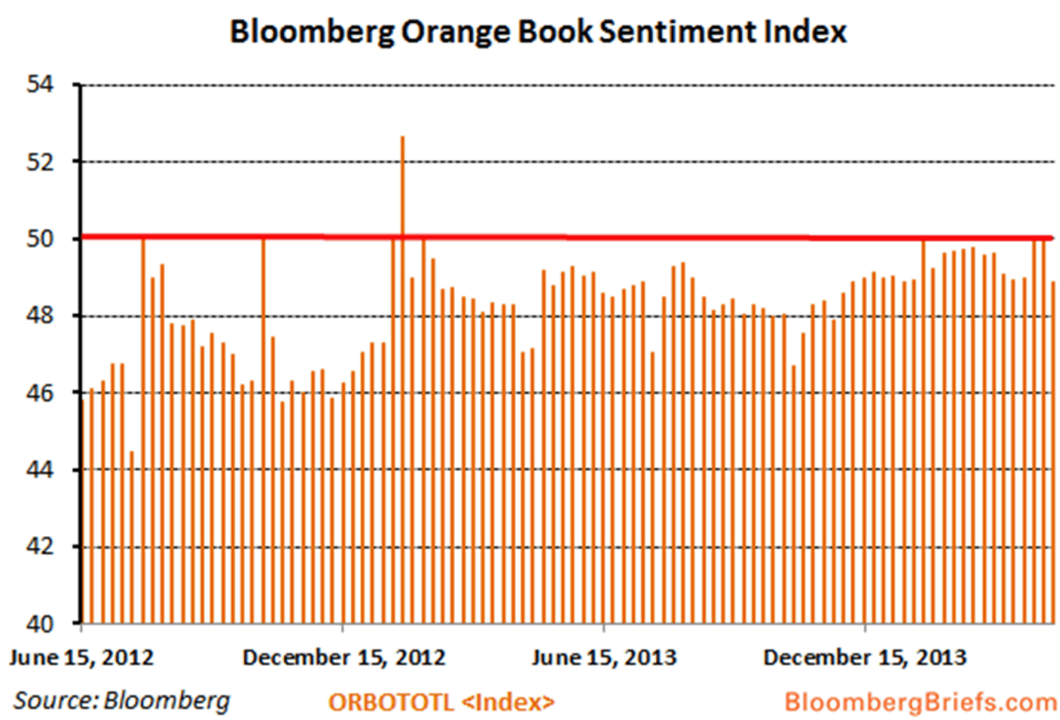
Minimum wage legislation and the Affordable Care Act (ACA) are at the forefront of business concerns. Some of these issues surfaced in this latest jobs report. The use of workers at temporary staffing places as a percent of total nonfarm payrolls climbed to 2.09 percent, the highest level since 1990.

Buffalo Wild Wings Vice President Emily Decker spoke at an Analyst Day event last week and noted, "Minimum wage increases are being proposed at the federal level and at the state level, with 11 states significantly increasing their minimum wage in 2014. For issues like this, we are actively working with legislators to explain how changes in the laws affect our business specifically, and the restaurant industry in general."

Similar concerns regarding minimum wage and the healthcare mandate were mentioned by Panera Bread, Wendy's, and Jack in the Box. These government regulations are weighing on business decisions to invest and hire. Don't expect any meaningful improvement in economic conditions until they are altered.

Even with the incessant complaints regarding the crippling effects of the weather on production, sales, confidence, employment and general economic conditions, the comments made during the quarterly earnings conference call season appear to be mostly positive, with the outlooks equally upbeat. Whether the lost business traditionally registered during the first quarter returns is yet to be determined. Issues remain with respect to poor currency translations, deflationary fears throughout Europe, and an uncertain situation in in Russia, Ukraine, and China.

The Bloomberg Orange Book of CEO Comments Sentiment Index has returned to a sub-50 posting in recent weeks, implying a continued sluggish economic recovery. Investors should expect more of the same since this indicator has been mired in a contractionary territory for more than a year-and-a-half.



Some of the comments from the current earnings season include:

Levi Strauss & Co [8089Z] Earnings Call 4/8/14: "We knew the first quarter would be challenging, but it turned out to be even more difficult than we expected. Our focus on our key strategies enabled us to maintain stable constant dollar net revenues, despite unfavorable weather conditions, continuing retail traffic declines, a competitive promotional environment, and ongoing softness in our U.S. women's wholesale business…"

Alcoa [AA] Earnings Call 4/8/14: "Overall volume is slightly higher versus the previous quarter. Improved industrial volumes in Europe were offset by weaker demand in North America. We continue to be impacted by the continued market pressure and unfavorable pricing impacts in packaging. Auto sheet volumes were strong, resulting in record automotive revenues. Improved productivity and cost containment combined with the favorable fixed costs absorption significantly benefited the result."

WD-40 [WDFC] Earnings Call 4/8/14: "Looking forward, we remain cautiously optimistic about several macroeconomic factors. As per our second quarter and year-to-date results, we expect that growth in EMEA and the Americas will continue to more than offset any lower industrial activity and sales in Asia-Pacific."

Family Dollar Stores [FDO] Earnings Call 4/10/14: "Our second quarter was particularly challenging, especially considering the significant impact that the severe weather had on our results. There were 18 named storms in the quarter, which resulted in more than 60 days being negatively impacted by winter weather. In addition, winter conditions disrupted merchandise deliveries, and snow accumulation and very cold temperatures resulted in higher than expected store maintenance and utility expenses."

JPMorgan [JPM] Earnings Call 4/11/14: "Despite a relatively favorable rate environment, the market got off to a slow start in 2014. We're seeing tight housing inventory in some markets, and the purchase market was affected adversely by the severe weather. This led to a challenging quarter for the mortgage business with production of $17 billion, down 27% quarter-over-quarter and 68% over last year."

Fastenal [FAST] Earnings Call 4/11/14: "The extreme weather that we had caused expenses to go up in more areas than you can imagine, simple things like snow plowing, the fuel, all of those things, heating expenses, but overall it's very challenging with the hard weather."

Wells Fargo [WFC] Earnings Call 4/11/14: "The housing recovery remained on track, and should benefit from the spring buying season. I'm optimistic about future economic growth, because consumers and businesses have continued to improve their financial conditions. Households have reduced their leverage to the lowest level since 2001 and the burden of their financial obligation is lower than at any time since the mid-1980s."

Goldman Sachs [GS] Earnings Call 4/17/14: "The first quarter reinforced two consistent themes that we have seen over the past few years: first, the continued uncertainty around the strength of the global economic recovery; and second, the dominant role that central banks play in driving broad economic activity and capital markets sentiment."

Sonoco Products Co. [SON] Earnings Call 4/17/14: "We're seeing improvement in certain domestic markets as well. For instance, we've experienced growth in dough, coffee, and nuts, which was partially offset by weather impacted categories like fiber, caulk, and snacks. However, both of these sectors are now rebounding. In addition, flexible volume continues to grow and we believe we've turned the corner in our thermoforming and blow-molding operations."

Chipotle Mexican Grill [CMG] Earnings Call 4/17/14: "While sales were understandably down during days of extreme winter weather. When the weather improved, our sales recovered to a higher level than before the extreme weather for a few days before settling back into a normal sales trend. The comp also benefited from an increase in the average check of about 2% and we benefited by about 1% from an extra trading day as Easter was in the first quarter of last year."

Sherwin-Williams [SHW] Earnings Call 4/17/14: "Consumer Group got off to a respectable start from a revenue perspective with organic sales up 1.6% in the quarter, but the harsh winter weather over the first two months of the year disrupted raw material deliveries that made it difficult to move finished goods across the northern half of the country and occasionally the southern half for that matter. This drove supply chain costs up, resulting in negative flow-through for the group in the quarter."

AutoNation [AN] Earnings Call 4/17/14: "Certainly, in the last 10 days of March with the thaw, business was exceptionally strong. We see the same intensity continuing into the month of April, which gives us optimism that in the second quarter we can recoup some of the disruption that occurred in the first quarter because of weather, which gives us the confidence to confirm our forecast for the full year of industry growth between 3% and 5% breaking through 16 million units."

Kimberly-Clark [KMB] Earnings Call 4/21/14: "I hate blaming weather for anything, and so – because you like to think that our products are more essential. So…people who have – didn't come to work didn't use hand towels, people that weren't able to get to the welding job site didn't use our safety products. And so we really lost hours of work in the first quarter."

A.O. Smith [AOS] Earnings Call 4/22/14: "We are cautiously optimistic about the developing recovery in U.S. housing. After a very strong water heater industry growth in 2015, helped by improved levels of home completion and significant expansion of the replacement market, we expect residential water heater volumes in the U.S. to be up to approximately 9 million units including tankless, primarily due to an increase in new home construction this year."

Deltic Timber [DEL] Earnings Call 4/22/14: "…the winter weather conditions that existed for much of the US during the first quarter had a chilling effect on markets for these companies' wood products. These conditions prevented builders from starting new homes, which resulted in decreased demand and lower prices for the dimension lumber used to construct these new homes. With these market conditions, we were forced to reduce our lumber production to meet the market demand…"

Genuine Parts Co [GPC] Earnings Call 4/22/14: "The extreme weather we encountered during the month of January, and even into February in some southern states as well as up and down the Eastern Seaboard, forced numerous store and customer closures and had a negative impact on our business."

P&G [PG] Earnings Call 4/23/14: "We continue to operate in a volatile environment with uncertainty in foreign exchange, deceleration in market growth rates, and a rapidly developing policy environment."

Manpowergroup Inc [MAN] Earnings Call 4/23/14: "As I look at the U.S. markets, we could see continued good, stable demand for almost all our service offerings. After some rough weather at the beginning of the year, we have seen demand and volume stabilize and improve across most of our brands."

Norfolk Southern [NSC] Earnings Call 4/23/14: "The impact of severe winter weather was concentrated in January and February, with March showing a fairly strong recovery. Clearly severe weather in the quarter depressed certain economic activity and shipments in the first two months of the year in particular."

Six Flags Entertainment [SIX] Earnings Call 4/23/14: "Attendance for the quarter declined by 434,000. As we discussed on our last earnings call, we anticipated a 300,000 decline in attendance in the quarter as a result of the shift of the Easter holiday and related school Spring Breaks at some of our parks into the second quarter this year. Unfortunately, in addition, we saw some very unfavorable weather at our two Texas parks during their Spring Breaks in early March, which accounted for the remainder of the decline."

Yamarone

You can learn more about the Bloomberg Economics Brief *here*.

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